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SYMPOSIUM ON U.S.-PACIFIC RIM RELATIONS

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

SECOND SESSION

DECEMBER 11 AND 12, 1986

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SYMPOSIUM ON U.S.-PACIFIC RIM RELATIONS

THURSDAY, DECEMBER 11, 1986

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 9:10 a.m., in room SR-325, Russell Senate Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey and Abercrombie; and Senator Sarbanes.

Also present: Richard F. Kaufman, general counsel; and Don Terry, Democratic staff director.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative Obey. Good morning.

I am pleased to welcome all of you to this 2-day conference on the economics of U.S. relations with the Asian countries of the Pacific Rim.

I have an opening statement which I would like to make. I don't intend to say everything that you see on the printed sheets in your hands but I will say some of it. The rest is on the record.

For the next 2 days, this conference will focus on this "ocean of the future," and the economic relationships which will help determine our prosperity in the years ahead.

Over the last decade we witnessed a profound reshaping of American economic ties with Asia. With the rise of Japan and the determined efforts of the newly industrialized countries to emulate Japan, the international center of gravity has slowly been shifting to the western side of the Pacific Basin.

When Commodore Perry steamed his black ships into Tokyo Bay many years ago, the Japanese were forced into an immediate recognition of Western military superiority. But because today's challenges have been more gradual, we have been slow to recognize their importance.

Today's "black ships" are freighters carrying a range of high quality manufactured goods produced by the export-oriented nations of the Pacific Rim. They are delivering to us the same message which Perry's ships delivered to the Japanese, but they are delivering it in smaller doses and in the more subtle garb of commerce. How we respond to this new challenge will shape economic opportunity for an entire generation of Americans.

This conference will focus primarily on the economic challenges posed to the United States by Japan and China, the two Asian superpowers, and by the NIC's, Taiwan, Singapore, South Korea, and Hong Kong.

For at least the past decade, these countries have been growing at astonishing rates. By the year 2000, it is estimated, at least by some, that Asia will constitute an economic power as large as the United States and larger than Europe.

That growth has been based largely on trade, particularly trade with the United States. But trade growth has certainly not been symmetrical.

Since 1980, exports to the United States from Japan have risen by 82 percent and have more than doubled from the other countries we'll be discussing in this symposium. Meanwhile, United Stated exports have remained flat to Japan and have risen by only 9 percent to the NIC's.

As a result, in 1985, more than $80 billion of our $140 billion merchandise trade deficit was produced by trade with countries of the Pacific Rim. Japan has the largest bilateral trade surplus with the United States. Taiwan has the fourth largest surplus; Korea the fifth; and Hong Kong the seventh.

The United States simply cannot go on indefinitely consuming more than we produce. The Asian Pacific countries cannot afford to be as dependent on U.S. markets as they have become and it would seem that that means that changes of habits are required on both sides of the ocean.

On our side, no single aspect of the problem is more troubling at least to me and I think to most Americans than the relative decline in the quality of a number of our manufactured products. We simply must learn how to produce goods of better relative quality and do so competitively if we are to match the production challenge of the Asian Pacific nations.

On the other side of the ocean, the Asian nations must consider ways of increasing their imports to produce a more mature and balanced pattern of growth less dependent on a large export surplus.

The subject of American product quality could be the subject of an entirely separate conference I suppose, but today and tomorrow we will be exploring U.S. relationships with the Pacific Rim in terms of two great challenges—the challenge of Asia as a competitor with the United States and the challenge of Asia as a market for the United States.

The most obvious and fundamental challenge to the United States is the competitive threat which Asian production poses for our industries.

If we were responding to that challenge in the same spirit which the Japanese demonstrated in response to Commodore Perry, we would undertake a searching reexamination of our own habits and our customs and our institutions. We haven't seen enough of that. Instead, we have often been comforting ourselves with a series of myths or semimyths which seek to explain away our sagging competitiveness.

The first comforting myth is that if the strong dollar would just go away so would most of our other problems. It's certainly true that the irresponsible budgetary policies of this administration, acquiesced in by this Congress and previous Congresses, have vastly distorted the value of our currency. But it is by no means clear that a falling dollar will reverse the deterioration of our competitive position in the Pacific Basin.

First, it is clear that export-oriented economies like those of Japan and the other countries under consideration today are reluctant to give up their international market share to foreign competition. And second, many of the smaller Asian countries are keeping their currency pegged to the dollar. They ride the dollar down, effectively devaluing their currency in step with the decline of the dollar. In that fashion they can maintain market share in the United States and gain market share in third country markets.

The second comforting myth is that while our Asian competitors may be gaining the competitive edge in declining basic industries, we still retain a leading position in "sunrise" industries such as electronics, communications, business services and finance. But a recent report done for this committee has shown this year, for the first time, the United States will run a trade deficit in "high technology" products as well as basic industrial products.

In all of the Asian countries, productivity growth is high, labor costs are low, and the ability to absorb, import and adopt the most advanced technology is, to say the least, impressive.

There is growing evidence that the Pacific Rim countries are looking to establish a strong international position in business services, an area traditionally dominated by American firms. Singapore has an impressive long-term plan for exporting services, particularly business services.

Japan is mounting a head-on challenge to American and European dominance of the international banking and financial services industry.

Japanese investment banks are using their financial resources to buy a stake in other financial markets.

A third myth is that Asian competitive success is due only to low labor costs. Since labor costs are now rising in those countries as development proceeds, one could suggest that eventually they would lose much of that advantage.

But again, reality does not match the myth. Japanese auto workers are paid roughly the same as their United States counterparts, but their productivity is some 20 percent higher, and the result is a significant cost advantage for Japanese producers. Korea seems to be following the same route. It's clear that the Asian nations are prepared to compete on the basis of advanced technology and high productivity, not merely on the basis of low labor costs.

Those examples—and many that I haven't cited—suggest that American industry faces a fundamental, not a transitory, competitive challenge from Asian Pacific producers. So far, the major response of much of American industry to this competitive challenge seems to be "if you can't fight 'em, join 'em."

For the past several years, American investment in the NIC's grew at 15 percent per year, far faster than American investment in our closer neighbors in Latin America. Much of that investment was used to establish new production facilities which exported their produce to the United States. Korea, for example, now makes forklift trucks for Caterpillar and jet-aircraft body structures for

Boeing. Next year we will see our new small Pontiac come from Korea.

Japanese firms have also set up production facilities in those countries to take advantage of high-skill, low-wage workers, but the focus of their export activities is radically different. U.S. manufacturing affiliates in Asian countries exported more than 60 percent of their products; more than 40 percent back to the United States and 19 percent to third countries. But Japanese affiliates in Asia exported only 33 percent of their product in 1979, 9 percent to Japan and 24 percent to third countries, selling 67 percent in the host country.

In other words, American firms set up factories in the NIC's to export back to America. Japan sets up factories to service the local market or to export to third countries, not to export to Japan.

That pattern is likely to pose an increasing threat in the coming years because the Asian host countries are increasingly demanding that American foreign investment involve the transfer of significant advanced technology and expertise. Traditionally, American firms wanted to reap the advantages only of cheap labor, but host governments have grown more resistant to this practice, objecting to the idea that the workers would still be just screwdrivers after ten years of the process.

To prevent them from remaining mere "screwdrivers", many countries have established performance requirements which mandate the transfer of technology and the location of specific production functions in the host country. As a result of those requirements, and a natural evolution of work toward the point of final production, firms are moving more and more of their advanced, high-value-added production offshore.

It is clear that we need to understand the nature of the competitive challenge posed by the Asian Pacific countries. It is equally clear that we need to develop a competitive strategy for our own economy to meet that challenge effectively.

But in addition to the competitive challenge posed by these countries, there is also an immense market opportunity for American firms in that region. Well over half of the world's population lives in the Asian Pacific region, some in rich countries like Japan, some in middle-income countries such as Taiwan and Korea, and some in low-income countries like the People's Republic of China. Taken as a whole, that market represents an enormous opportunity for all kinds of American firms.

If businessmen in my district, as rural as it is in this country, have been exploring the opportunities of the Chinese market, believe me, it's significant because it's a cold day in you know where when most businessmen in my district take a look at foreign markets anyplace, let alone something as different as China in comparison to our own.

That's an opportunity which we have to encourage and develop.

Historically, growth in the Asian market for American goods has been retarded because of limited per capita income, because of an export-oriented development strategy, and because of lack of sufficient aggressive export promotion by American firms.

The rapid growth of national income in the Asian Pacific nations should reduce the first problem, but the second two obstacles are more intractable.

Most of the countries have followed the Japanese pattern of pursuing prosperity through export growth rather than through expansion of the domestic market. For small countries like Singapore and Hong Kong, that may make good economic sense. But for others, it may not.

But market growth in those economies has been limited both by culture and by policy.

It would seem that that pattern simply has to change. No great or aspiring economic power can base its prosperity solely on the exploitation of foreign markets. And there are some signs that this reality is being recognized, at least in Japan. The recent publication of the Maekawa Report has focused national attention on Japan's need to import as well as export, and I hope that the first of today's panels will explore more fully the implications of this report for Japan's future development.

But even if the countries of the Pacific Rim undertake the reforms necessary to stimulate domestic demand, substantial uncertainty remains about whether U.S. firms will be able to sell effectively in Asian markets. Selling in any market requires extensive local knowledge, requires marketing contacts and lots of aggressive promotion, and there is substantial evidence that American firms are not doing very well at those tasks.

One major reason for weak marketing of American products in Asia is American lack of familiarity with Asian languages and Asian customs. In 1983, only 13,000 American students were enrolled in programs of Chinese language study, only 16,000 were studying Japanese, and only 635 were studying Korean. By contrast, there were 32,000 Chinese, 13,000 Japanese, and 16,000 Koreans with sufficient English fluency to be enrolled as students in American universities and colleges in that same year.

By some recent accounts, there are only a handful of American business executives located in Japan who can converse without an interpreter, and even fewer American businessmen in China who can do so.

If the Asian market grows substantially, there is every reason to assume that other countries will reap the benefits and not the United States.

The slowness of American business in penetrating Asian markets is not the fault of business alone. Education policy in this country has never encouraged or promoted Asian studies, and the U.S. Government has not provided American businessmen with the kind of export assistance needed for effective marketing in Asia.

Last year, for example, the Chinese Government gave the U.S. Commerce Department an immense file of data on Chinese consumers and their buying habits. After analyzing the data, the Commerce Department decided not to publish it because of budget constraints. Instead, they offered it for sale at $300 a copy and they sold the grand total of ten copies.

But one of those copies was purchased by the Japanese External Trade Organization office in New York, which immediately recognized how useful that data could be to Japanese firms trying to penetrate the China market. JETRO immediately had the data translated into Japanese and gave it away for free to 710 major Japanese corporations with an interest in selling to China. Other firms could purchase it for a mere $10.

There are many other reasons, obviously, for America's trading and competitive difficulties. American cultural habits and our almost theological belief in certain economic principles or myths, depending on how you view them—rugged individualism, for instance, versus a tradition of cooperative or clean play—have prevented us from engaging in the tactical planning needed to position ourselves to compete as effectively as we should. Our total domination of almost everything in the two decades after World War II lulled us into producing products which were not responsive to market changes and did not match customers' expectations of quality. Mr. Darman and others have touched on those problems and I assume that the subject will receive much broader attention in the next few years.

More than a century ago, as I mentioned previously, the West presented a dramatic challenge to Asia in the form of military and commercial superiority. In very different ways, the major countries of the Pacific Rim responded to those challenges with fundamental and even revolutionary changes. Both China and Japan overthrew their feudal political systems and reorganized their economies along radically new lines. The success of Japan in that effort is breathtaking, and there are some who believe that China's entry into the world market could be even more dramatic over the next generation.

The Asian response to the Western challenge has itself created a new Asian challenge for the West. We not find ourselves in fierce economic competition with those very same countries.

If we are wise, we will respond as Asia did, by rigorous examination of our own economic practices and serious attention to the strengths and weaknesses of our competitors. And it is our hope that this conference will be part of the process that will help us to choose wisely.

[The complete opening statement of Representative Obey follows:]

INTRODUCTORY REMARKS
BY
DAVID R. OBEY
CHAIRMAN
JOINT ECONOMIC COMMITTEE

I am pleased to welcome you all to this two-day conference on the economics of U.S. relations with the Asian countries of the Pacific Rim. President Reagan has called the 21st Century the Pacific Era, and one economist described the importance of this part of the world in these terms:

> The Mediterranean was the sea of the past. The Atlantic is the ocean of the present. But anyone who fails to recognize that the Pacific is the ocean of the future is likely to pay a high price for his oversight.

For the next two days, this conference will focus on this "ocean of the future", and the economic relationships which will help determine our prosperity in the years ahead.

The Joint Economic Committee has for many years sought to inform Congress about developments in countries which have great significance for the U.S. In the past, this has meant conferences, hearings and publications on the economies of the Eastern Block, because they had been perceived as our major international rivals. Now it is clear that another challenge -- just as important and just as real -- will be coming from the Pacific Rim. That fact requires some significant reorientation in our thinking.

A century ago, it was the United States which took the lead in defining the economic and trade relationships in the Pacific Basin. Commodore Perry's famous "black ships" provided the military muscle to forcibly open Japan to western trade and influence. The Philippines was an American colony and American traders helped open and defend the "treaty ports" which were feudal China's only window to the outside world.

For most of the twentieth century, and particularly after the Second World War, American economic leadership and the security umbrella provided by what many have called "Pax Americana", provided a framework within which the nations of the Pacific Rim were able to make extraordinary economic progress.

The U.S. security umbrella freed Japan of the necessity of committing resources to defense. It permitted a more rapid accumulation of private investment capital than would otherwise have been possible. When America was a trade surplus nation, the export of American capital helped establish new businesses in many Asian countries. And the American market provided the major source of demand for the exports of Asian nations.

As one commentator put it, Pax Americana was a better deal for Nissan and Hyundai than it was for General Motors.

But over the last decade, we have witnessed a profound reshaping of American economic ties with Asia. With the meteoric rise of Japan, and the determined efforts of the Newly Industrializing Countries to emulate Japan, the international economic center of gravity has been slowly shifting to the western side of the Pacific Basin.

When Commodore Perry steamed his black ships into Tokyo Bay, the Japanese were forced into an immediate recognition of Western military superiority. But because today's challenges have been more gradual, we have been slow to recognize their importance.

Today's "black ships" are freighters, and their cargo is the vast range of high quality manufactured goods produced by the export-oriented nations of the Pacific Rim. They are delivering to us the same message which Perry's ships delivered to the Japanese, but they are delivering it in smaller doses and in the more benign garb of commerce. How we respond to this new challenge will shape economic opportunity for an entire generation of Americans.

BRIEF REVIEW OF THE FACTS

This conference will focus primarily on the economic challenges posed to the U.S. by Japan and China, the two Asian superpowers, and by Taiwan, Singapore, South Korea and Hong Kong collectively known as the NICs'--Newly Industrializing Countries.

For at least the past decade, these countries have collectively been growing at astonishing rates. In 1960, the Asian Pacific countries accounted for only 11 per cent of world gross domestic product (GDP), in comparison with 36 per cent of the U.S. and 23 per cent for Europe. By 1980, Asia had grown to 18 per cent of world GDP, and the U.S. had shrunk to 24 per cent. By the year 2000, it is estimated that Asia will constitute an economic power as large as the U.S. and larger than Europe.

That impressive growth has been based largely on trade, particularly trade with the U.S. For the past eight years, US trade in the Pacific has outstripped trade across the Atlantic to Europe. Today, nearly half of all U.S. manufactured imports came from Asia, and 21 per cent from Asia excluding Japan.

But that trade growth has not been symmetrical. With the exception of China, the Asian nations have elected to emulate Japan's strategy of growth through export promotion rather than growth through expansion of the internal market. The result has been rising trade surpluses for most Asian countries, particularly bi-lateral surpluses with the U.S.

Since 1980, exports to the U.S. from Japan have risen by 82 per cent, and have more than doubled from the NICs, while U.S. exports have remained flat to Japan, and have risen by only 9 per cent to the NICSs.

The result of that imbalanced growth is a huge and growing trade deficit between the U.S. and the Pacific Rim nations. In 1985, more than $80 billion of our $140 billion merchandise trade deficit was produced by trade with the countries of the Pacific Rim. Japan has the largest bilateral trade surplus with the U.S., but Taiwan has the fourth largest surplus, Korea the fifth, and Hong Kong the seventh.

And the imbalances are not just with the United States. Japan has the largest current account surplus in the world, running well in excess of $80 billion per year. Taiwan has a $12 billion current account surplus, and has built up foreign exchange reserves of more than $40 billion in the past few years. Korea enjoys an enormous merchandise trade surplus, but has only a small current account surplus because of its extensive debt service obligations.

These figures pose dangers both to the United States and to the nations of the Pacific Rim. The U.S. simply cannot go on indefinitely consuming more than we produce. The Asian Pacific countries cannot afford to be as dependent on the U.S. market as they have become. In 1984 the United States took 49 percent of Taiwan's exports, 35 percent of South Korea's, 33 percent of Hong Kong's, and 20 percent of Singapore's.

This means that when the U.S. economy catches a cold, many Pacific Rim economies have to be rushed to the emergency room. In 1985, for example, when U.S. growth slowed noticeably, exports from all the Asian NICs either stagnated or declined. As a result, growth rates fell in all the Asian nations. Taiwan grew by barely half the rate enjoyed in 1984, while Hong Kong slid from 9.6 per cent growth to less than 1 per cent, and Singapore actually experienced a 1.7 per cent decline in GNP.

To accomplish the needed realignment of trade in the Pacific Basin, habits on both sides of the ocean must change. On our side, no single aspect of the problem is more troubling to me, and I think most Americans, than the relative decline in the quality of many of our manufactured products. We simply must learn how to produce goods of better quality and to do so competitively if we are to match the production challenge of the Asian Pacific nations.

On their side, the Asian nations must consider ways of increasing their imports to produce a more mature and balanced pattern of growth, less dependent on large export surpluses.

The subject of American product quality could be the subject of an entirely separate conference, but today and tomorrow we will be exploring U.S. relations with the Pacific Rim in terms of two great challenges: the challenge of Asia as a competitor with the U.S. and the challenge of Asia as a market for the U.S.

ASIA AS COMPETITOR

The most obvious and fundamental challenge to the U.S. is the competitive challenge which Asian production poses for our industries. The rapid surge in imports from Japan and the NICs is evidence that U.S. industry is having a difficult time retaining its leadership in the American domestic market. But the American market is only part of the problem. In the past six years, the Asian Pacific nations have also been increasing their exports to other markets, a trend which has increased in the past year.

If we were responding to this competitive challenge in the same spirit which the Japanese demonstrated in response to Commodore Perry, we would undertake a searching re-examination of our habits, customs and institutions. We would pay close attention to the techniques, practices and strategies of our more successful Asian competitors.

We haven't been seeing enough of that. Instead of conducting a searching re-examination, we have been comforting ourselves with a series of myths which seek to explain away our sagging competitiveness.

The first comforting myth is the strong dollar. While it is certainly true that the irresponsible budgetary policies of this Administration have vastly distorted the value of our currency. But it is by no means clear that a falling dollar will reverse the deterioration of our competitive position in the Pacific Basin.

First, it is clear that export-oriented economies like those of Japan and the NICs are reluctant to give up their international market share to foreign competition. Companies like Sony, Nissan, Toyota and Hitachi each export more than 50 per cent of their total output. Instead of raising prices and giving up market share, they are cutting profits in order to retain their share of the market.

Second, many of the smaller Asian countries are keeping their currencies pegged to the dollar. They "ride the dollar down", effectively devaluing their currency in step with the decline of the dollar. In that fashion, they can maintain market share in the U.S. (where the price of their goods remains the same), and gain market share in third-country markets, where their falling currency lowers the price of their exports. Hong Kong, for example, is boasting a 25 per cent increase in exports to West Germany so far this year - an improvement that is entirely due to exchange rate shifts.

The second comforting myth is that while our Asian competitors may be gaining the competitive edge in declining basic industries, we still retain a leading position in such "sunrise" industries as electronics, communications, business services and finance. But a recent report done for the Joint Economic Committee has shown that this year, for the first time, the U.S. will run a trade deficit in "high technology" products as well as basic industrial products.

In all of the Asian countries, productivity growth is high, labor costs are low, and the ability to absorb, import and adapt the most advanced technology is almost literally mind boggling.

Last year, the Korean firm of Daewoo designed an IBM-compatible personal computer, which Consumer Reports has described as "the best buy among IBM compatibles." Taiwan has launched a $200-million joint venture for making VLSI (Very Large Scale Integrated) semiconductors, which are used in computers.

Even the People's Republic of China has been moving toward establishing an export industry in high-technology products and services. The Chinese are providing rocket launch services for scientists. They have enlisted the help of Korea and Singapore in establishing plants to manufacture, among other things, color television sets, refrigerators and computer disk drives.

Finally, there is growing evidence that the Pacific Rim countries are looking to establish a strong international position in business services, an area traditionally dominated by American firms. Singapore has an impressive long-term plan for exporting services, particularly business services. Through aggressive promotion of data processing, communications and financial services, Singapore is demonstrating considerable success in becoming a headquarters site for major multinational corporations.

Japan is mounting a head-on challenge to American and European dominance of the international banking and financial services industry. Japan's huge trade surplus gives it vast reserves of capital which it is deploying in a strategic fashion to establish a leading position in international capital markets.

Last year, Nomura Securities, Japan's largest investment bank, had profits nearly four times those of Morgan Stanley, nearly double Merril Lynch's, and about the same as Salomon Brothers'. Big profits provide an investment bank with room to make mistakes in a very risky business. So, since 1983, Japan's investment banks have been able to bid combatively for the underwriting of bond issues in the Euromarkets and, as a result, to increase their market share.

Japanese investment banks are also using their financial resources to buy a stake in other financial markets. Nomura securities recently purchased a 20 per cent stake in Babcock and Brown, a British securities dealer, while Sumitomo has recently moved to acquire an interest in Goldman Sachs.

Japanese securities firms are also moving aggressively to help American corporations raise funds in both Yen and dollars. Earlier this year, a Japanese securities firm helped General Electric raise funds in the European dollar markets, since many of the investors purchasing Eurodollar bonds are Japanese. More American companies are likely to follow suit, raising serious questions about the competitive position of the American investment banking industry.

A third myth is that Asian competitive success is due only to low labor costs. Since labor costs are rising in all these countries as development proceeds, one might imagine that eventually they would lose their labor cost advantage.

But again, reality does not match the myth. Japanese auto workers are paid roughly the same as their U.S. counterparts, but their productivity is some 20 per cent higher, and the result is a significant cost advantage for Japanese producers. Korea seems to be following the same route. Daewoo Heavy Industries has started developing and deploying its own industrial robots despite relatively low Korean labor costs. It is clear that the Asian nations are prepared to compete on the basis of advanced technology and high productivity, not merely low labor costs.

These examples suggest that American industry faces a fundamental, not a transitory, competitive challenge from Asian Pacific producers. So far, the major response of much of American industry to this competitive challenge seems to be "if you can't fight 'em, join 'em".

For the past several years, American investment in the NICs grew at over 15 per cent per year, far faster than American investment in our closer neighbors in Latin America. Much of this investment was used to establish new production facilities which exported their product to the U.S. Korea, for example, now makes forklift trucks for Caterpillar and jet-aircraft body structures for Boeing. Next year's new small Pontiac will also come from Korea.

Japanese firms have also set up production *facilities in the NICs to take advantage of high-skill, low wage workers, but the focus of their export activities is radically different. U.S. manufacturing affiliates in Asian countries exported more than 60 per cent of their products -- 41 per cent back to the U.S. and 19 per cent to third countries. But Japanese affiliates in Asia, export only 33 per cent of their product in 1979 (9 per cent to Japan and 24 per cent to third countries), selling 67 per cent in the host country.

In other words, American firms set up factories in the NICs to export back to America. Japan sets up factories to service the local market or to export to third countries, not to export to Japan. Thus the investment activities of our businesses add to the American trade deficit, while the investment activities of the Japanese firms produce quite a different result.

This pattern is likely to pose an increasing threat in the coming years, because the Asian host countries are increasingly demanding that American foreign investment involve the transfer of significant advanced technology and expertise. Traditionally, American firms wanted to reap the advantages only of cheap labor, but host governments have grown more resistant to this practice. As one official put it:

> We don't want our workers to be still just screwdrivers after 10 years

To prevent them from remaining mere "screwdrivers", many countries have established performance requirements which mandate the transfer of technology and the location of specific production functions in the host country. As a result of those requirements, and a natural evolution of work toward the point of final production, firms are moving more and more of their advanced, high-value-added production offshore. Fairchild Semiconductor, for example now now does much of its design work in Singapore.

It is clear that we need to understand the nature of the competitive challenge posed by the Asian Pacific countries. It is equally clear that we need to develop a competitive strategy for our own economy to meet that challenge effectively.

ASIA AS MARKET

But in addition to the competitive challenge posed by the Asian Pacific nations, there is also an immense market opportunity for American firms in this region. Well over half of the world's population lives in the Asian Pacific region, some in rich countries like Japan, some in middle income countries such as Taiwan and Korea, and some in low-income countries like the People's Republic of China. Taken as a whole, this market represents an enormous opportunity for all kinds of American firms, but it is an opportunity which we must encourage and develop.

Historically, growth in the Asian market for American goods has been retarded by three factors: limited percapita income, an export-oriented development strategy, and lack of sufficient aggressive export promotion by American firms.

The rapid growth of national income in the Asian pacific nations should reduce the first problem, but the second two obstacles to American export growth in Asia are more intractable.

Most of the countries have followed the Japanese pattern of pursuing prosperity through export growth rather than through expansion of the domestic market. For small countries like Singapore and Hong Kong, this clearly makes good economic sense, but South Korea, Taiwan and especially Japan have large populations which could be major markets for U.S. goods.

Market growth in these economies has however been limited by both culture and policy. The cultural imperatives of frugality and high savings help restrain consumer demand, while tax, budgetary and regulatory policies also tend to reinforce a pattern of slow growing domestic demand.

It is clear that this pattern must change. No great or aspiring economic power can base its prosperity solely on the exploitation of foreign markets. And there are encouraging signs that this reality is being recognized, at least in Japan. The recent publication of the Maekawa Report has focused national attention on Japan's need to import as well as export, and I hope that the first of today's panels will explore more fully the implications of this report for Japan's future development.

It is not yet clear that the other Pacific Rim nations have taken heed of the implications of the Maekawa Report, but that report contains vital lessons for any country experiencing a large and growing current account surplus. To maintain a growing world trading system, we need to maintain a more balanced world trading system, and a development strategy based on export promotion and chronic current account surpluses simply cannot be a viable long run strategy for any major nation.

But even if the countries of the Pacific Rim undertake the reforms necessary to stimulate domestic demand, there remains substantial uncertainty about whether U.S. firms will be able to sell effectively in the Asian market. Selling in Asia requires extensive local knowledge, marketing contacts and lots of aggressive promotion, and there is substantial anecdotal evidence that American firms are not doing well at these tasks.

Take for example the question of automobile sales in Japan. There is significant demand for large, heavy luxury cars in Japan, but this market is almost completely dominated by the Germans. American firms have only a tiny presence in this market, since they have refused to accommodate Japanese driving habits by producing right-hand drive cars. The Germans, who were willing to produce right-hand drive cars, effectively dominate the foreign luxury car market in Japan.

One major reason for weak marketing of American products in Asia is the American lack of familiarity with Asian languages and Asian customs. In 1983, only 13,000 American students were enrolled in programs of Chinese language study, only 16,000 were studying Japanese, and only 635 were studying Korean. By contrast, there were 32,000 Chinese, 13,000 Japanese and 16,000 Koreans with sufficient English fluency to be enrolled as students in American universities and colleges in that same year.

By some recent accounts, there are only a handful of American business executives located in Japan who can converse without an interpreter, and even fewer American businessmen in China.

If the Asian market grows substantially, there is thus every reason to assume that other countries, probably other Asian countries, will reap the benefits and not the United States.

In the case of China, for example, it would appear that Singapore's entrepreneurs are better positioned than are Americans to take advantage of the new openness. Chinese residents of Singapore speak Mandarin, which is the dialect most widely used in China, and not the Cantonese dialect used in Hong Kong. Singapore entrepreneurs have already developed close contacts with the Chinese government, and could well be a major presence in that market in the coming years.

The slowness of American business in penetrating Asian markets is not the fault of business alone. Education policy in this country has never encouraged and promoted Asian studies, and the U.S. government has not provided American businessmen with the kind of export assistance which is needed for effective marketing in Asia.

Last year, for example, the Chinese government gave the U.S. Commerce Department an immense file of data on Chinese consumers and their buying habits. After analyzing the data, the Commerce Department decided not to publish it because of budget constraints. Instead, they offered the data for sale at $300 a copy, and sold fewer than 10 copies.

But one of those copies was purchased by the Japanese External Trade Organization (JETRO) office in New York, which immediately recognized how useful the data could be to Japanese firms trying to penetrate the China market. JETRO immediately had the data translated into Japanese and gave it away for free to 710 major Japanese corporations with an interest in selling to China. Other firms could purchase the publication for a mere $10.

CONCLUSION

There are many other basic reasons for America's trading and competitive difficulties. American cultural habits and our almost theological belief in certain economic myths have prevented us from engaging the the tactical planning needed to position ourselves to compete as effectively as we should. Our total domination of almost everything in the two decades after World War II have lulled us into producing products which were not responsive to market changes and did not match customers expectations regarding quality. Mr Darman and others have touched on these problems, and I assume the subject will receive much broader attention in the next few years.

More than a century ago, the west presented a dramatic challenge to Asia in the form of military and commercial superiority. In very different ways, the major countries of the Pacific Rim responded to these challenges with fundamental, even revolutionary changes. Both China and Japan overthrew their feudal political systems and reorganized their economies along radically new lines. The success of Japan in this endeavor has been breathtaking, and there are many who believe China's entry into the world economy will be even more dramatic over the next generation.

The Asian response to the Western challenge has itself created a new Asian challenge for the West. We now find ourselves in fierce economic competition with export-oriented, highly productive and efficient economies. If we are wise, we will respond as Asia did: by rigorous examination of our own economic practices and serious attention to the strengths and weaknesses of our competitors.

If we are foolish, we will simply ignore or dismiss the Pacific Challenge. I hope that this conference will be part of a process of helping us choose wisely.

Representative OBEY. Before we move to the introduction of the first panel, I would like to welcome two of my colleagues here. The person who came in first is Congressman Neil Abercrombie of Hawaii, and the person seated next to me, as I'm sure most of you know, is the soon-to-be chairman of this committee, Senator Paul Sarbarnes of Maryland. I am pleased that both gentlemen could be here today and I know that when Paul takes over this committee he will be a vigorous chairman who will examine many of these same areas that we are looking at today.

I might ask you, Paul, if you have any comments before we begin the first panel.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you, Mr. Chairman. I will be very brief.

This is another in a series of symposia which the Joint Economic Committee has been holding during the course of Dave Obey's tenure as chairman of the committee. As you all know, the chairmanship bounces back and forth from Congress to Congress between the House and Senate.

Beginning with the 40th anniversary symposium, which I think assembled as impressive a group of thinkers on economic issues as has been put together in recent years and in fact whose deliberations have now been published as a book by Basil Blackwell, Chairman Obey has tried to do, I think with great success, something that is often neglected in the Congress. That is, while dealing with the current issues that press in upon us and need to be handled on almost a daily or weekly basis, to focus also on developing issues, to take a look into the future to see where the trends are leading and to anticipate what their development might bring.

This symposium is another example of that and we are very pleased to have such a distinguished group of participants in it. The panelists you will hear from this morning, this afternoon, and then tomorrow morning are all acknowledged to be leading experts in the field. We think they are going to shed a good deal of light on an issue which is obviously of paramount importance to future economic developments, not only with regard to the United States but with respect to the international economy.

So I am very pleased to join with the chairman in opening this symposium, and to underscore the fine leadership which Dave Obey has given to this committee, especially his willingness to include in its work a dimension that looks beyond the immediate to the question of where we are going in the future. If we would do more such thinking, we could handle the current problems more effectively as they arise, in my judgment.

Representative OBEY. Thank you, Paul.

I would now like to turn to our first panel which will examine the probable course of the Japanese economy through the end of the century.

Since Japan is the premier economic power in the region, its economic evolution is of more than passing interest in any review of the Pacific Rim situation.

A closer look at Japan is particularly timely at a time when major changes in demographics, politics and economic policy seem to have been put in motion as the country tries to cope with the burdens of becoming a truly great and successful economic power.

We are fortunate to have as the moderator for this panel Mr. Peter Behr, economics writer for the Washington Post, and a long-time student of American and Japanese economic relations. Mr. Behr will doubtless provide this panel with the kind of clarity and focus which characterizes his reporting on international competitive issues.

Peter, why don't you take over and do whatever you want to do.

Panel 1.—Peter Behr, Moderator

Mr. BEHR. Thanks, Congressman Obey.

We are fortunate to have five experts with us to try to shed light on the relationship between the United States and Japan, a relationship that is entering a crucial turning point some 40 years after the end of the Second World War. Four of the panelists are among the foremost American academic experts on the United States-Japanese relationship, and they are joined by a professor of economics at Kyoto University who is a visiting professor at Columbia University.

The first panelist is Prof. Thomas McCraw of the Harvard Business School, who is the Director of Research and Chairman of their Business, Government, and Competition Area; and the editor of a new book called "American Versus Japan" which is a group of case studies about the American and Japanese competition across a wide range of industries in economic areas. Let us begin with Professor McCraw.

STATEMENT OF THOMAS K. McCRAW, DIRECTOR OF RESEARCH AND CHAIRMAN, BUSINESS, GOVERNMENT, AND COMPETITION AREA, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, HARVARD UNIVERSITY

Mr. McCRAW. Well, let me describe briefly how we came to write this book. I am a historian by profession, sort of the token historian in this group, the one virtue being that the historian usually gets to go first because he or she usually gives historical background for whatever is to follow.

This book that we wrote is written by a combination of 14 people, scholars, some of them at the Harvard Business School and some of them elsewhere, assisted by 20 or 30 interpreters and translaters. All of the authors made three or four and sometimes five or six trips to Japan of a duration of 2 or 3 weeks each.

We started out with the idea of comparing America and Japan. I will show you a copy of it because the cover design of the book shows that America and Japan are sort of inextricably linked. One of our premises is that the two are so interdependent that to try to pull them apart economically would be impossible at this stage of history.

I also am not selling the book because I've provided you with a summary of it that will prevent you having to shell out $29.95, the price of the book. If you want to wait on the Japanese edition, as in so many other ways, it's less expensive. It will be about $15. Had it been published in the United Kingdom with their printing costs, it would be about $60. So things change in international publishing as well as international competition in other industries.

But I want to go as a historian would by what has happened in the past and what is likely to happen in the future if present trends continue, so I ask you to take out this summary of the book because I want to speak from some numbers for about 10 minutes and then try to see what the numbers tell us.

This is the rather thick packet labeled "America Versus Japan: A Comparative Study."

When we began, we had only the comparative dimension in mind. The "versus" had its meaning only as "compared with." It had no collision course implication.

As we got into the study, which took about 4 years, it began to dawn on all of us that the situation we were discovering seemed to be an unsustainable and sort of disequilibrating, as an economist would say, kind of situation.

If you look at the first page you see the familiar GNP numbers of America compared with Japan, compared with the EEC countries. You see the familiar double digit growth rates in Japan in the 1960's. If these numbers were extended back in the 1950's you would see the same thing—the story of the Japanese economic miracle.

You also see the very healthy growth rate of the United States economy during the 1960's and approximately the same thing in the EEC countries.

Then with the supply shocks and other severe dislocations of the 1970's, each of these GNP numbers is cut approximately in half. This is all familiar to all of you so I won't dwell on it except to say that the 1986 numbers are likely to be on the order of 2 percent, maybe 2.3, for both America and Japan.

Table 2 is something that came as a surprise to almost all of us in the sense that not only is it unprecedented that the U.S. budget deficit has become so enormous—President Reagan's remark about the 67-mile-high stack of thousand dollar bills has now doubled—I don't think the 67 was right in the first place. It was more like 71 or so. But whatever it was, it's now doubled and may even triple by the time President Reagan goes out of office.

The surprising thing was the Japanese number, at least to us, how, as a percent of GNP, the Japanese fiscal deficit had quadrupled in 10 years.

The reason for that is that a slowdown in the growth rate combined with the installation of a welfare state caused the kind of deficit you see.

If I had to pick two numbers on this table to circle, it would be the 1984 number in the United States, the miracle growth rate of 6.5 percent, combined with the U.S. deficit in the same year in table 2 of $185 billion.

What those two numbers show is that the original plan of growing our way out of the deficit simply does not work, even though we had that one miracle growth year in 1984 which by I think no coincidence, as a historian would point out, was an election year.

Now if you turn the page to table 3, I've tried to compress a great deal of information into these bar graphs and it points out I think one thing that is very new that goes beyond the fiscal deficit as a problem in itself.

This is the relationship of these numbers to each other. The familiar propensity of the Japanese to save and invest is quite evident simply by the height of the bar graph compared not only to the low U.S. numbers but to the German numbers, which one would expect to be higher, but in fact are nowhere near as high as the Japanese.

The key thing on here—and if I had 30 minutes I'd like to talk about that, but since I only have 10 minutes I will just call attention to the fact that the black bar (total investment) plus the gray bar (fiscal deficit), in the case of the United States, exceeds the dotted bar (total savings). This is a new situation which means that the American deficit is being financed abroad. The United States is the only one of the three countries in which those two exceed domestic private savings.

As you know, our deficit is being financed in very significant measure from abroad and especially from Japan. But one has to ask the question, if one is the American Secretary of the Treasury, say, in 1993 when, if these present trends continue the U.S. will be a net foreign debtor of $1 trillion—that number, by the way, comes from the Industrial Bank of Japan—what one might be tempted to do.

I think the temptation would be to devalue the currency or force a revaluation of the yen but of a larger magnitude than we have seen since late 1985.

Now if you look at tables 4 and 5 we see again very familiar numbers and I won't dwell on these except to call your attention to the orders of magnitude.

My premise here is that, as Yogi Berra once said, "You can see a lot just by looking." And if you just look at this, we've become desensitized with these numbers because we've heard about them so many times. Americans are sick of hearing about level playing fields and Japanese unfairness and the miracles of Japanese management. The Japanese are sick of hearing Americans talk about or whine about unlevel playing fields.

So both countries, in my judgment, have become somewhat desensitized with the realities, and the reason I put these numbers before you is to call attention to the unprecedented orders of magnitude that they represent. Not only the fiscal deficit as we saw in the first two tables, but also the trade deficit.

These are simply unprecedented. And again, in 1986, a new record for the sixth consecutive year will be set in both countries. What those numbers will be I don't know, but it will be probably over $160 or $170 for the United States and probably a $60 billion surplus for Japan, probably in excess of a $60 billion deficit United States with Japan.

Now table 5 is the kind of thing that you would expect from a business school professor—a list of companies showing the top 10 manufacturing exporters of each country. If you average exports as a percent of sales on the Japan side—that is the one that starts with Toyota 45 percent and ends with Sony at 69 percent, arithmetic average of that is 48 percent.

These are not the most dramatic numbers one could offer. The most dramatic ones would come in other industries, each of which has an 80 percent export ratio. Those are 35 millimeter cameras in Japan, watches in Japan, and VCR's produced in Japan. That is to say, four out of five units produced are exported.

It's almost as if the same situation that prevailed in the late 1940's and early 1950's in which the Japanese produced large amounts of toys for Americans, were being reproduced here except the toys have become a good deal more expensive and the export of the toys has become damaging, at least in terms of market share, to domestic toy manufacturers, whether they be Swiss watches or European VCR makers or American electronics firms or camera companies located in Germany.

The other thing I would call your attention to is that only three industries basically are represented on the Japan side, and that's automobiles, electronics and electrical machinery, and steel, the one Nippon steel case. I think the No. 11 company is NKK (steel) with a 30-odd-percent export ratio, No. 12 is Sanyo which is in the 60's. So this not an exception.

On the American side, the export ratio has an arithmetic average of 15 percent. What you see here by looking—and again, I refer to the great genius Yogi Berra—what you see by looking here is that American defense contractors make up a fair number of the 10 companies on the list. The investment costs to develop aircraft sold by Boeing or McDonnell-Douglass or United Technologies was socialized in America as part of the Pentagon's effort to promote R&D. So a way somewhat similar to the Japanese side, the initial steps were to socialized investment costs, follow experience curved pricing strategies and gain a significant market share.

While you might wonder why GM, Ford, and Chrysler on this top 10, one of the reasons for that is there's a lot of across-border shipment between Windsor and Detroit that tends to show up here that are not really exports. GM and Ford are big competitors in the world, but it's usually not exported from Detroit. It's usually Ford of Europe or GM of Europe which are very strong companies producing abroad.

The next page presents a contrast which to me, as the coauthor of this book and as the author of the particular chapter in which these production and distribution comparisons are made, is perhaps the most striking structural difference that we came across; and I want to underline the term "structure" because I think that's the essence of the problem.

That's not to say that we do not have a macroeconomic or exchange rate problems, but those problems I think are easier to deal with than the structural problems which get one involved in the culture, of which my colleagues here on the panel will say a good deal more about in a moment.

Now I have chosen the steel industry here because that's where the best studies are done. One might point out that the Japanese steel industry is in trouble right now, as indeed it is, from Newly Industrializing Countries such as Korea, Brazil, and others; but these studies, which were done about 10 years ago show, as I say in this note at the bottom of the page, are a kind of metaphor that one might apply to the auto industry or to the electronics industry or to the heavy equipment industry.

The point is that the economies of scale and the state-of-the-art technology that is represented by these companies and plants on the left hand side of the column for Japan is absolutely staggering when compared to the American.

At the end of World War II the Japanese steel industry had a production capacity of about 2 million tons. By the time these studies were done, it was 150 million tons. And yet the same companies were doing the producing and only the technology and the size of the plant had grown. All of these plants, by the way, were basic oxygen technology, which was not true of all the U.S. plants. As you can see, the U.S. plants are about half the size.

You might think so what? Well, "so what" is that in integrated steel scale economies are almost unbelievably large and so that the bigger, the more efficient, and the greater potential for increasing market share. So that by the time this came to pass, the United States was importing a great deal of its steel and Japan was exporting about 40 percent of the production that you see here.

The real story, however, is to contrast what's in table 6 with what's in table 7. In table 7, I have contrasted not the production sector but the distribution sector as it shows up in retail companies and the top 10 in each country.

Here, I ran into an apples and oranges problem because, as anyone who's gone to Japan and shopped and been to the United States and shopped knows, it's not the same thing. You don't see Safeways and Krogers and other kinds of things in Japan, nor do you see Ito-Yokado type stores in the United States in which groceries are on the first floor, clothing on the second, and the stores are typically stacked, in part because of limited land availability.

But the overall point is evident I think just from looking, and that is that what you saw on the preceding page, the scale economies represented by production, are exactly reversed in terms of distribution in the retail sector.

The same thing might be true in wholesaling as well, as we'll see on the next page, but what I want to emphasize here is that these are structural things that are built into the economies of both of these countries and are going to be exceedingly hard to change without changing the habits of shopping of people in both countries.

Some people argue that this Japanese legal restriction on distribution is a kind of deliberate nontariff barrier to the marketing of foreign goods in Japan. I don't think that that's true. I think that's a convenient circumstance for the Japanese, but I don't think that that was the reason for it.

At any rate, the numbers I would say speak for themselves and I would ask you to review this if you take this thing away and think about what the implications of all this might be.

The next page, table 8, underscores the point that the Japanese distribution system differs not only from the American but from that of most other comparable industrialized countries at this stage in the history of industrialization, which I remind you is only about 150 years. We're not talking about a very long period here.

In fact, I would also emphasize that in American-Japanese relations we are talking in historical terms about the twinkling of an eye, just that much, about 50 years in which the countries have gone from being unrelated, to an extraordinarily tragic and bloody Pacific war, to an atypical occupation period, to the Japanese economic miracle which is perhaps the most interesting of all phases of the last 50 years, to a situation today where they are on, in my judgment, a collision course simply because these numbers are unsustainable.

On the collision course—I should also remind you that many things happen on collision courses. I flew down here. We were on a collision course with another airline. That's the reason we have air traffic controllers. Ships at sea get on collision courses all the time. Probably one-tenth of 1 percent of all collision courses end in collision. So I am not arguing that there will be a collision between America and Japan, economic or otherwise.

What I am arguing is that the course is there and unless some adjustment is made by the pilots of both ships or both aircraft, there might well be a collision that will end in a trade war directed by the United States against Japan. That's the bottom line.

I do not think that's going to happen and God knows I hope it doesn't happen and I don't think anyone in here hopes it will happen.

At any rate, back to the structural difficulties in table 8, you will see the significant numbers here are the third lines from the top and that is population per wholesaler where Japan has simply more wholesalers than appear to be necessary to run a modern economy, and especially retailers, which is the bottom line—population per retailer, 69 in Japan, 117 in the United States, 160 in Britain, 180 in West Germany.

I'm not arguing here that the U.S. distribution system is the best in the world. I think perhaps the British is and that's one of the reasons why the British have perhaps deindustrialized faster than anybody else. They are able to suck in imports and distribute them very rapidly in much the same way that the United States is coming to do in the 1980's—a machine for sucking in imports the same way that Japan represents a machine for producing exports. And the machine and the structure is all geared to it and most of the parts of the machine are designed to do just that.

When I have spoken on this subject of retailing and wholesaling to my Japanese friends, they have remarked that certain aspects of Japanese culture and especially the topography—that is, the limited land—force Japanese concerns to behave in this way. I would concede 50 percent of that argument, but then I would ask, if that is true, then why are there laws against big stores, which I have summarized here at the bottom.

No one has been able to answer that question yet and when I have interviewed people in MITI who were responsible for trying to rationalize the distribution system they say, "Your hypothesis is correct, but your conclusion is understated; it's much worse than you have said when you came in here to talk to us and we could tell you a lot but we would get into trouble if we did."

Now on the last page, again, numbers with which we are becoming familiar but which contain a little bit of surprise and you can see a lot again just by looking.

Employees in EEC countries work fewer number of hours per year than does the United States, which in turn works fewer than Japan. Now as any academic can tell you, one cannot measure efficiency or output by the number of hours on the job. If I sit in my office for 12 hours, I may just be doing absolutely nothing and the same is true with Japanese workers.

But the fact is that these are interesting numbers and we all know that Japanese work harder. Their usual work week is 5½ or 6 days.

More significant, the vacation days are extraordinarily few in Japan (14.6), about half what they are in Germany which we regard as a very hard-working country, 3 out of 5 of what they are in the United States. Even more striking is the 8.2 vacation days per year which them average Japanese private sector employees takes.

I asked a group of Japanese executives with whom I was speaking, about 75 of them, last August, "How do you feel on these 8.2 days? Do you feel guilty that you should be on the job?" And the consensus was that, yes, they did and that they wondered what was going on or what positions were being undermined in office politics during those 8.2 days in which they were away.

Table 12 underscores a point that Chairman Obey made a moment ago and that is—and I think this is kind of a national disgrace for the United States—our inward-looking, provincial attitude, our notion that somehow or other we don't need to understand other countries.

The absolute numbers on the college students, the way I derive this 15 to 1, a thirtyfold effort if you take the population disparity into account is that about 800 Americans are studying in Japan versus about 12,000 Japanese in the United States. By comparison with the 800 in Japan, there are probably 2,700 in Italy, most of them studying are in Florence, Venice, or Rome, and there's no argument that that's inappropriate, it's just an argument that if we are talking about economic things, then this is the thing we ought to focus on.

I would end by saying that from a historical point of view, structural and cultural things are extraordinarily difficult to change. It is not strictly a macroeconomic problem. The macroeconomic place may be the place to start, mainly with the U.S. fiscal deficit. Until something is done about that, this situation is going to continue. But beyond that, the structural difficulties of changing behavior in both countries—the consumer-driven American economy and the producer-driven Japanese economy—are among the hardest things to change in human history.

That's the end of my remarks, Peter.

[The complete statement of Mr. McCraw follows:]

AMERICA VERSUS JAPAN: A COMPARATIVE STUDY

Edited by Thomas K. McCraw

(Boston: Harvard Business School Press, 1986)

1. Introductory Tables
2. Chapter Summaries
3. Biographies of Authors

Table 1

Growth Rates in Real Gross National Products, 1961-85, Annual Averages (%)

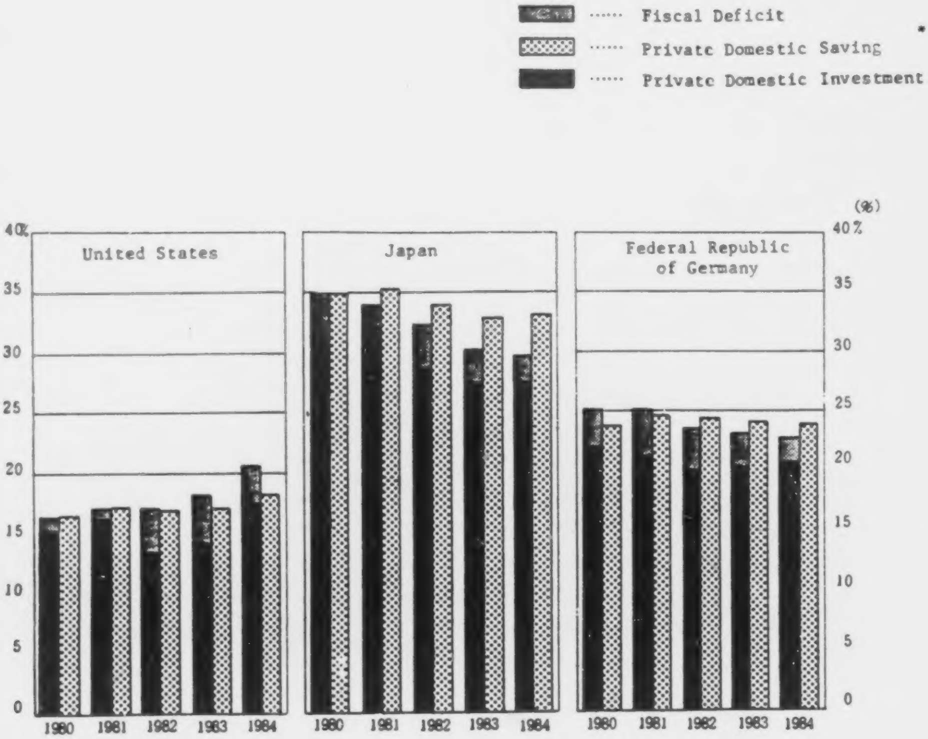
	1961–65	1966–70	1971–75	1976–80	1981	1982	1983	1984	1985
Japan	10.0	11.3	4.6	5.1	4.2	3.1	3.3	5.8	5.0
USA	4.6	3.0	2.2	3.4	1.9	−2.5	3.5	6.5	2.3
EEC Countries	4.7	4.4	2.7	3.0	−0.2	0.5	1.2	2.1	2.2

Table 2

	U.S. Federal Deficit	Total Federal Debt	Debt as % of GNP	Japan's National Deficit	Total Nat'l Debt	Debt as % of GNP
1975	$ 53.2 b	$544.1b	36.8	¥ 5.3 t	¥15.0 t	9.9
1980	73.8	914.3	35.5	14.2	70.5	29.3
1981	78.9	1003.9	34.8	12.9	82.3	32.3
1982	127.9	1147.0	37.7	14.0	96.4	36.1
1983	207.8	1381.9	42.9	13.5	109.7	39.4
1984	185.3	1576.7	44.0	12.9	122.0	41.0
1985	212.3	1827.5	46.4	11.7	132.9	42.3

Table 3

General Government Deficits, Private Domestic Saving, and Investment



Additional Facts:

1. From 1914 until July 1985, the U.S. was a net creditor nation.
2. By 1990, if present trends continue, the U.S. will be a net debtor of $750b.
3. By 1993, if present trends continue, the U.S. will be a net debtor of $1 trillion.
4. Most of these foreign obligations will be in U.S. government bonds.
5. In 1986, the total foreign obligations of all Latin American governments is about $500 billion.

Table 4

Overall Trade Balances
(With All Nations)

	USA	Japan	USA Deficit with Japan	
1975	$ 2.2 bil.	$ −2.0 billion	1975	$ −1.6 billion
1980	−36.2	−10.9	1980	−10.4
1981	−39.6	8.6	1981	−15.8
1982	−42.6	6.9	1982	−17.0
1983	−69.4	20.6	1983	−21.1
1984	−123.3	33.5	1984	−37.0
1985	−143.8	39.6	1985	−40.7

Table 5

The Top Ten Manufacturing Exporters of Each Country (1984)

	Exports	Exports as % of Sales		Exports	Exports as % of Sales
1. Toyota	$10.4 b	45 %	1. G M	$ 7.3b	9 %
2. Nissan	8.9	58	2. Ford	6.0	12
3. Honda	5.8	71	3. G E	3.9	14
4. Matsushita	5.1	37	4. Boeing	3.6	35
5. Hitachi	4.1	37	5. I B M	3.1	7
6. Nippon Steel	4.1	34	6. Chrysler	2.7	14
7. Mazda	4.0	67	7. Du Pont	2.7	7
8. Toshiba	3.1	29	8. United Technologies	2.4	15
9. NEC	2.7	34	9. McDonnell Douglas	2.1	22
10. Sony	2.6	69	10. Eastman Kodak	1.9	18

Table 6

The Ten Largest Integrated Steel Plants in Each Country, 1977-78

Units: Millions of Net Tons of Crude Steel Capacity

Japan		United States	
Fukuyama (NKK)	17.6 million	Indiana (Inland)	8.5 million
Mizushima (Kawasaki)	14.0	Gary (U.S. Steel)	8.0
Chiba (Kawasaki)	10.0	Sparrows Pt. (Bethlehem)	7.0
Kimitsu (Nippon Steel)	10.5	Great Lakes (National)	6.6
Wakayama (Sumitomo)	10.2	E. Chicago (J & L)	5.5
Kashima (Sumitomo)	9.9	Burns Harbor (Bethlehem)	5.3
Yawata (Nippon Steel)	9.7	South Chicago (USS)	5.2
Oita (Nippon Steel)	9.2	Fairless (USS)	4.4
Nagoya (Nippon Steel)	8.3	Cleveland (Republic)	4.4
Kakogawa (Kobe)	7.1	Wierton (National)	4.0

NOTE: At this time, the minimum efficient scale of an integrated steel mill, while somewhat problematical, was widely regarded as about six million tons. During these same years, five different studies of the steel industries of the two countries revealed that on the whole, Japanese producers averaged a cost advantage of between $61 *per ton* (the lowest estimate) and $120 (the highest) over American producers.

Similar studies, with similar results, have been done of the two countries' automobile, electronics, and other industries. The table above is only one example of Japan's strategy of scale economies in the manufacturing sector.

Table 7

Department Stores/General Merchandisers

Japan			U.S.A.		
Company	Annual Sales	Number of Stores	Company	Annual Sales	Number of Stores
1. Daiei*	$5.1 billion	166	1. Sears*	$35.9 billion	831
2. Ito-Yokado*	3.6b	116	2. K-Mart**	18.6b	2370
3. Seiyu*	2.9b	164	3. Safeway¶	18.6b	2454
4. Jusco*	2.9b	148	4. Kroger¶	15.2b	1262
5. Nichii*	2.3b	160	5. Penney*	12.1b	1984
6. Mitsukoshi§	2.2b	14	6. Southland§§	8.8b	7722
7. Takashimaya§	2.0b	6	7. Federated§	8.7b	508
8. Daimaru§	2.0b	8	8. Lucky¶	8.4b	1590
9. Seibu§	1.9b	10	9. American¶	8.0b	1027
10. Uny*	1.6b	104	10. Winn-Dixie¶	7.0b	1222
Average	$2.65b	89	Average	$14.1b	1994
			Average without Southland:		1472

Key: * = General Merchandise Stores, which in Japan usually include food sales

¶ = Supermarkets, which in each country sell food plus other items as well

§ = Department Store Chains

** = Discount Houses

§§ = Convenience Stores (Southland in America operates 7-Eleven stores, of which there are now nearly eight thousand. Under a contractual agreement with Southland, Ito-Yokado operates about 1400 7-Elevens in Japan, which are not included in Ito-Yokado's totals above.)

Table 8

International Comparisons of Wholesalers and Retailers

	Japan	Britain	France	W. Germany	United States
Number of Wholesalers	369,000	57,000	97,000	113,600	383,000
Employees per Wholesaler	10	14.8	6.4	9.9	9.4
Population per Wholesaler	315	1,095	542	540	565
Number of Retailers	1,673,000	351,000	533,000	340,500	1,855,000
Employees per Retailer	3.6	6.9	2.6	6.1	8.1
Population per Retailer	69	160	99	180	117

Table 9

Limitations on the Rationalization of Retailing Imposed by Japan's Government:

1. 1973: Diet passes Large-Scale Retail Store Act, discouraging the opening of new stores of more than 1500 square meters' floor space. Average number of applications for new stores of that size drops by about 50%, to about 150 per year in the 1980s. (Japan's population is about 120 million persons.)

2. 1978: Pressed further by lobbying from small-scale retailers, Diet passes powerful amendments to 1973 law, now regulating the opening of new stores of only 500 square meters. New applications for such stores drop in same pattern as after 1973 Act.

3. 1981-82: Additional limitations on large stores through "administrative guidance," urged on Ministry of International Trade and Industry by the ruling Liberal Democratic Party, which depends on votes of small-scale retailers.

Table 10

Total Numbers of Hours Worked Per Year by Private Sector Employees

EEC Countries	1500-1600 Hours
United States	1800
Japan	2100

Table 11

Paid Vacation Days Per Year for Private Sector Employees

West Germany	30 days
France	25
United States	19.6
Japan	14.6*

*Of the 14.6 days to which Japanese employees are entitled, they actually took (in 1984) an average of only 8.2 vacation days.

Table 12

In the 1980s, for every American studying in Japan, approximately 15 Japanese students were attending universities in the United States. Considering the disparity in the two countries' populations, this represents approximately a 30-fold effort of Japan to understand the United States compared with that of the United States to understand Japan.

FROM PARTNERS TO COMPETITORS

by

Thomas K. McCraw

This chapter is an introduction to the book. It provides a broad historical survey of the macroeconomic performance of the Japanese and American economies, and emphasizes the different methods of policymaking for business. It outlines ways in which the two countries' contrasting goals and different methods of decision making led them gradually from a pattern of complete cooperation onto what may well be a collision course, based on trade friction.

The chapter begins with a sketch of the anatomy of the Japanese economic miracle, focusing on the years 1954-1971. Here, Japanese policy is presented as a matter of deliberate choices:

a. The choice to develop capital-intensive, high value-added industries, as opposed to those labor-intensive industries in which Japan might be thought to have possessed a comparative advantage;

b. The choice to close the Japanese home market to manufactured imports until such time that Japanese domestic producers could compete successfully with foreign importers;

c. The careful selection and targeting of export markets, especially the United States, which represented a rich, open, and friendly market--in part because American foreign policymakers wished to build up Japan as an example of democratic capitalism in the Northwest Pacific;

d. The choice by Japanese business and government of a particular kind of development strategy, emphasizing a pay-as-you-go pattern of savings and investment, rather than one relying on any of three other clear alternatives: public ownership of the means of production, heavy foreign borrowing, or heavy foreign direct investment by American and European multinational corporations;

e. The choice of acquiring high technology through all four available sources: a long-term, grow-your-own strategy, emphasizing training of scientists and engineers within Japan; a joint-venture sourcing of technology, involving agreements with high-tech foreign companies such as IBM and Texas Instruments; a purchase and licensing pattern, such as the deals made with RCA and other firms; and a reverse-engineering strategy, followed by numerous companies such as Toyota and Fujitsu. Of these four, the chapter argues that the last two were more important in the early years, but that all four eventually became significant sources of technology for the Japanese economy.

Overall, the chapter finds the economic miracle a triumph of effective business-government coordination, especially in the microeconomic sphere. The achievement was fundamentally the work of Japanese business executives and company workers; but the architect of the setting in which the miracle occurred was the Japanese government--especially the elite economic ministries such as MOF and MITI.

Finally, the chapter brings the historical material up to date with a series of elementary statistics on world economic growth, trade imbalances, and growing public deficits in both the United States and Japan. The central argument is that these trends of the 1980s are likely to place an increasing strain on overall Japanese-American relationships, and that a better understanding of each country by the other will be required to preserve the remarkable Japanese-American friendship characteristic of the years 1945-1986.

PROTECTING WORLD MARKETS: THE UNITED STATES AND JAPAN IN WORLD TRADE

by

David B. Yoffie

International trade has gone through turbulent times since the oil shocks of 1973. Growth in world exports and imports has been more uneven than in any comparable period since the 1920s, and a whole array of unusual new trade barriers, ranging from voluntary export restraints to barter requirements, have been erected to protect favored markets. The implications of this trend are potentially ominous for all nations. Should the world retreat into protectionism, there would be no winners.

For the United States and Japan, the first and third largest traders in the world, global protectionism would be especially devastating. Both nations have become deeply dependent upon international trade since World War II. Yet, despite the United States' and Japan's common concern for trade, and despite a shared fear of increasing protectionism, their governments and firms have employed fundamentally opposite strategies. The results of these differences have been among the key factors which turned Japan into one of the premier trading nations, while contributing to the relative decline of the United States.

I argue that the United States' strategy for international trade started to emerge in the mid-1930s and blossomed in the late 1940s. The strategy dictated that American interests would best be served with the twin objectives of liberal international trade and the subordination of domestic economic interests to global political considerations. Helping American firms maintain their dominant position was not an issue. By contrast, modern Japanese trade policy, from the early 1950s through the 1980s, has been molded around the principle of domestic self-interest. In Japan's trade strategy, external economic expansion has taken precedence over other domestic and international political concerns.

Both strategies on international trade were responses to the crises of their time. In each country, the strategies slowly gained legitimacy, and ultimately became deeply influential in government organizations. Both countries have largely maintained those same basic principles of forty years ago, even though their markets and politics have been transformed.

The remainder of the chapter examines the recent forces for change in trade policy in the United States and Japan. I start by exploring the interaction of Japanese business and government in two cases of foreign protectionism -- countertrade restrictions in Indonesia, and limits on the export of video tape recorders to Europe. I found that many Japanese firms were exerting increasing independence from MITI and the Japanese government, but that the traditional relationship of mutual dependence between Japanese companies and their government in trade has not been significantly altered in recent years.

American trade policy, faces many of the same inertial pressures that have impeded change in Japan. Using a brief case study of U.S.-Japanese conflicts over trade in telecommunications, I illustrate why only modest changes have occurred in America's approach to trade. I show that despite America's enormous trade deficit, the basic American trading strategy has continued to emphasize international politics and liberal trade. Threats of increased U.S. protectionism and a more activist trade strategy have remained more symbolic than real.

The paper concludes that the trading strategies of both nations will not change significantly unless American or Japanese corporate and government leaders perceive a severe external crisis. Japan must become convinced that the world, and especially the United States, will no longer tolerate its growing surpluses; and the United States must be convinced that it has a trade problem, and not simply a monetary or macroeconomic problem.

PRODUCTION AND DISTRIBUTION: COMPETITION POLICY AND INDUSTRY STRUCTURE

by

Thomas K. McCraw and Patricia A. O'Brien

This chapter argues that a remarkable double paradox exists between the production and distribution sectors of the United States and Japan:

1(a). In Japan, the production sector (especially production for export) has achieved extraordinary success. The chapter devotes considerable space to the evolution of the Japanese steel industry into the world's most efficient, with the most modern equipment, and the greatest economies of scale. This modern, efficient overall production sector is matched for imports and exports as well, primarily through the device of the *sogo shosha*, which together account for about one-half of all Japanese imports and exports.

1(b). The *domestic* Japanese distribution sector, however, has not modernized nearly as much. In retailing, hundreds of thousands of "Mom and Pop" stores exist, alongside a few modern chains and department stores. Similarly, the wholesale sector appears to be much larger than necessary, with multiple layers of distribution points, many of which appear to be unnecessary. The number of middlemen per capita in Japan exceeds that in either the United States or the developed nations of Europe--the very same industrialized countries in which Japan's exports have been so remarkably successful. During the period of miracle growth, relative backwardness in distribution did not pose serious problems: modern supermarkets, chain stores, department stores, and convenience chains could grow without unduly displacing the business of the numerous small retail establishments. After growth slowed, however, the Japanese government took explicit steps to protect small retailers from additional competition from large stores.

2(a). In the United States, the pattern has been almost exactly the opposite. The American steel industry, which a few decades ago was the world's largest and strongest, experienced a decline during the years 1950-1975, until it became cost-inefficient compared with the Japanese industry. The chapter argues that a different set of investment decisions was responsible for these dramatic differences: in America, the individual companies were prevented by antitrust laws from cooperating to limit output and protect prices; in Japan, these devices were actually sponsored by the government, then institutionalized under the jishu chosei programs. The outcome of American failure and Japanese success appears to cast doubt on some fundamental tenets of traditional economic theory: that protectionism in the form of import prohibitions inhibits efficiency; that cartelization does the same thing; and that free and unfettered market competition yields the strongest and most economically efficient outcomes. The actual experience of the steel industries in each country suggests that the theory should be modified to take into account different industry dynamics and designed by coordinated business-government arrangements.

2(b). In the retail sector of the United States, rationalization has proceeded very rapidly, despite protests from small business interest that parallel the protests found in Japan. The difference is that, whereas in Japan the small distributors won government assistance in the form of protection from large chains, in the United States the small distributors lost the political battles, time after time. One striking fact is that whereas the political fights became most intense in America during the 1920s and 1930s, and were settled at those times largely through the intervention of courts, in Japan the battles continue into the 1980s, and are managed by MITI and local chambers of commerce, acting under the basic laws passed by the Diet in 1974 and 1979.

CROSS-INVESTMENT:
A SECOND FRONT OF ECONOMIC RIVALRY

by

Dennis J. Encarnation

Everyone knows that the United States and Japan are in disagreement over trade. Less well-known is a second front of economic competition: American-Japanese cross-investment in factories, assembly plants, warehouses, and sales offices. Such cross-investment is not a recent development, yet its use as a potent commercial weapon is new, one that did not even exist for the Japanese a decade ago. In 1974, for example, Japan's direct investments in the United States were one-tenth the size of otherwise small American investments in Japan. But between 1979 and 1984, all of this changed, as Japan moved ahead of Canada, Germany, and Switzerland to become America's third largest foreign investor, behind Britain and the Netherlands.

What did not change, however, was Japan's unique concentration in downstream wholesale trade. In fact, by 1984, the book value of Japanese investment in the U.S. wholesale sector alone -- mainly in selling autos and other durables -- exceeded the value of all American investments in Japan. These Japanese-affiliated wholesalers distributed at least 70% of all Japanese exports to America, and they gave Japanese manufacturers an unusual degree of control over the marketing of their exports to America. These investments also provided Japanese policymakers a mechanism for recycling ever-growing export receipts, in an effort to quiet U.S. critics of Japanese trade policies. But, somewhat paradoxically, most new Japanese investments entered the U.S. wholesale sector, where they stimulated even more Japanese exports.

The composition of those exports gradually changed, however, as components began to be shipped to new Japanese assembly and manufacturing plants [illegible] America. While small in relation to investments in U.S. wholesaling, Japanese investments in U.S. manufacturing nevertheless experienced rapid growth, despite the widely touted reluctance of Japanese enterprise to invest in manufacturing overseas. That reluctance began to disappear when Japanese exporters faced many of the same conditions that once sent American multinationals to Japan: trade barriers and, to a lesser extent, the demands of local buyers and the competitive pressure of concentrated industries.

Japanese manufactures, like their earlier American counterparts, sidestepped these trade barriers by investing within the now-protected market. But unlike the Americans, Japanese investors typically owned a controlling interest in their new American affiliates. Several Japanese multinationals also exploited their earlier beachhead in U.S. wholesaling by integrating backward into assembly and manufacture. And, in patterns even more pronounced than among Americans, Japanese manufacturers often moved sequentially to America, following their industry leaders. When Japanese manufacturers moved, they tended to bring their suppliers along. Given this constellation of forces between 1974 and 1984, Japanese investments in U.S. manufacturing grew rapidly — in fact, twice as fast as U.S. investments in Japan.

At this juncture in the history of American-Japanese cross-investments, the greatest threat to bilateral relations is a growing asymmetry, evident since 1984 — with Japanese investments in America now almost two times larger than U.S. investments in Japan. This new "investment gap" like the already present "trade gap," adds further credence to the claim that Japan has moved much too slowly in opening its markets to Americans, while buying up some of America's most productive assets.

AGRICULTURE: THE POLITICAL ECONOMY OF STRUCTURAL CHANGE

by

Michael R. Reich, Yasuo Endo, and C. Peter Timmer

Conflicts between Japan and the United States over agricultural trade represent common problems in international relations. No country really likes to negotiate agricultural policies with another country. Those policies are often based on historically constructed domestic agreements that have developed strong constituencies. Moves toward more liberal international trade can affect those domestic agreements, with adverse economic and political consequences. Agricultural policy therefore represents an important realm of national sovereignty that political leaders seek to protect from outside interference.

This chapter uses an analysis of agricultural policies and trade conflicts to examine the political economy of structural change. The first section of the chapter briefly explains the problems that structural change in the economy creates for agriculture. Next, the chapter analyzes the strategic choices of Japanese and United States agricultural policy in confronting the issues of structural adjustment. The third section discusses the politics of agricultural policy development in both countries, as revealed by the trade dispute over beef and oranges. The chapter's conclusion sets forth lessons for future agricultural trade relationships between the United States and Japan.

The chapter argues that the central issue for the long-term adjustment of Japanese agriculture is rice production and especially rice price policy. Through the government's general support system for the producer price of rice, Japan's farmers receive about four times the world price of rice, and often much more than that, depending on prevailing exchange rates. That policy has skewed the allocation of resources in

Japan's domestic agriculture toward rice production and away from other crops. It has also contributed to the high cost of land, and thereby played a major role in making Japanese agriculture high cost, small scale, and uncompetitive. That policy, in effect, requires protection for many Japanese crops and agricultural products to assure their survival. Such protection, in turn, puts Japanese agricultural policy in conflict with the policies of other countries, including the United States, that seek export markets for agricultural crops to resolve their own domestic issues of structural adjustment.

Short of starting a retaliatory trade war, the recourse in such situations is to enter bilateral trade negotiations, just as the United States and Japan did over beef and citrus. But it must be recognized that enormous stakes were on the table, stakes not even hinted at by the small value of trade in these two particular commodities.

Japanese negotiators were being asked to bargain over basic elements in their domestic agricultural policy, elements which have powerful political and income distribution consequences for Japanese society. No country willingly puts such issues on the bargaining table. They arrived there only because of intense political and economic pressures from the United States. Neither the process nor the outcome were what trade economists would design if they had a blank sheet as a starting point, but that is precisely the point of this chapter. Even on issues so fundamental as the structure of an economy and how it copes with changing sectoral competition during the course of development, political choices influence, even determine, the path. These choices in turn alter the vested interests along the path and hence feed back to the choices themselves. Structural change is therefore at least as much a matter of politics as it is of economics.

ENERGY MARKETS AND POLICY

by

Richard H.K. Vietor

In Japan and the United States, markets define energy strategies, while institutional structure shapes implementation. These are the two principal themes of this chapter.

In both countries, energy companies are privately owned, yet regulated closely by government. In most other countries, government owns the energy companies. For this reason, the national energy strategies of Japan and the United States -- despite obvious differences in their indigenous resources -- have been shaped by imbalances in the world oil market. Since World War II, these have changed course four times, corresponding to shifts in the supply, demand, and price of petroleum worldwide. Implementation, meanwhile, has depended largely on the structure of industry and government, and on the institutional means for managing business-government relations.

This chapter is divided into three parts. Part I contrasts energy resources and the structure of industry and government in Japan and the United States. This analysis highlights the political implications of concentrated, industrial users and relatively homogeneous producers in Japan, compared to dispersed residential and business users in the United States, and producing sectors that are structurally diverse or geographically segmented. There is a parallel contrast in political structure -- Japan's strong bureaucracy with America's strong legislature.

In part II, I describe the conduct of energy policy over time, as the international oil market fluctuated from glut to shortage, and back again. Here, I focus on the domestic petroleum industries and the importation of liquefied natural gas (LNG). These two sectors illustrate a range of policy tools and business-government relations, from active day-to-day control to passive, long-term guidance. While the Japanese government managed oil-industry structure inefficiently, the Americans managed oil imports and prices even less efficiently. LNG, by contrast, is an administrative success story in Japan; while its failure as a business in the United States is a tribute to the efficiency of deregulation.

In conclusion, the third part of the chapter offers my own observations about the nature and effectiveness of business-government relations in the two countries. The goals of national strategy consist of both substantive and procedural content, but in dramatically different proportions in the two countries. Implementation of economic policy requires a minimum of administrative discretion and institutional channels for meaningful deliberation. And finally, strategies and policy tools are effective when they conform reasonably well to the broad dimensions of the market.

COPING WITH CRISIS: ENVIRONMENTAL REGULATION

by

Susan J. Pharr and Joseph L. Badaracco, Jr.

Governmental authorities in Japan and the United States faced a common challenge at the outset of the 1970s. Strong commitments in both countries to fostering dynamic economic growth had, as an unintended and largely unnoticed consequence, set in motion a process of deterioration of the environment. By the late 1960s, as a result of numerous events in both countries and of the media attention they received, popular consciousness had been raised, and with it came a public demand for a strong governmental response.

In both Japan and the United States, the legislative branch seized the initiative--a common pattern in the United States but unusual in Japan given the powerful initiating role generally played by bureaucracy. In both countries--in an extraordinary break with past policies--there was an explicit rejection of economic arguments as an appropriate basis for deciding environmental policy.

Fifteen years later, a broad consensus in both countries held that environmental crisis had been averted. The body of environmental law developed in the 1970s was still in place in 1986. In both countries, public opinion surveys revealed that popular support for environmental measures remained strong. But the sense of tremendous urgency had passed. Leading activists from the 1970s, were prepared to acknowledge in 1985 that very significant gains had been made, even if much remained to be done. Air and water quality by most measures had improved significantly in both countries. Environmental agencies were fully in place in both countries, although both were quite weak compared to longer established parts of the bureaucracy.

This chapter examines how Japan and the United States moved from the atmosphere of crisis and challenge in the early 1970s to the status quo of 1986, focusing on the pattern of government-business relations that took shape in each country in the politics of regulation. The "cooperative approach," as it operates at its best in Japan, is well illustrated by the response of major chemical companies and the government in the mid-'70s to the problem of reducing workers' exposure to vinyl chloride, an invisible carcinogenic gas used to make plastic products. As the case study presented in the chapter demonstrates, public and private officials in Japan worked together with remarkable effectiveness to resolve the vinyl chloride issue. The road to government-business cooperation on environmental policy, however, was a stormy one. And, indeed, the vinyl chloride case reveals a level of government-business cooperation that has seldom been achieved, even in Japan, in the area of environmental policy.

If the vinyl chloride episode constitutes a "best case" of Japan's response to pollution, it is important to examine a "worst case" to illuminate the government-business response in the early stages of coping with environmental issues. The "worst case" was Japan's response to one of the country's earliest pollution crises, Minamata disease. Initially, government and business "cooperation" took the form of implicit collusion to avoid regulatory initiative or response. The chapter makes the argument that it was only the watershed events of the early 1970s and a national consensus on the desirability of pollution control that grew out of them, that forced government and business into an uneasy partnership to regulate the environment in Japan. Here the media played a major role. How the modus vivendi between government and business developed is well illustrated by examining a more typical case of environmental regulation that emerged after national consensus was achieved; namely, industry's response to auto emissions controls.

Overall, the pattern of government-business relations in Japan over the past 20 years may be seen as having moved from collusive to conflictual to cooperative, whereas in the United States, government-business relations in environmental policy have been persistently adversarial. If any change can be identified in the United States it would be a subtle shift from an adversarial approach to an increasingly collusive one.

FROM RELATIONSHIP TO PRICE BANKING: THE LOSS OF REGULATORY CONTROL

by

M. Colyer Crum and David Meerschwam

This chapter describes and compares the Japanese and U.S. financial systems. It argues that each system sought the same goal of financial stability and each permitted the mobilization and deployment of funds for distinctive national purposes.

Despite a historical emphasis on decentralization and fragmentation of power in the United States and an emphasis on centralization and coordination of power in Japan, the financial systems in the two nations historically operated in similar ways. Each system comprehensively restricted the ability of financial institutions to choose among alternative patterns of obtaining or deploying funds. These product-strategy limitations were a mixture of regulation of products, prices and operating procedures and in concert with the behavior of the institutions themselves severely reduced the freedom of each type of institution to maneuver. This lack of freedom greatly weakened the bargaining power of the financial institutions and strengthened the control of financial regulators in both nations.

Individual financial institutions and their customers tried to escape from the traditional regime in both nations. These leakages were increasingly overlooked or tolerated as the lesser evil and the regulatory structure was undermined. Finally, the system was assaulted by massive outside pressures: in Japan, the slowdown in economic growth caused by the first oil shock and the resulting large government deficits and in the United States, the oil shocks, enormous LDC loans, and inflationary and deflationary pressures. The result in both nations was a breakdown of regulatory discipline and its restrictions on choice. No longer were institutions and customers bound together in long-term relationships but instead were free to alter asset and liability strategies based on market prices.

Domestic forces in each nation caused deregulation, which occurred earlier in the United States than in Japan; but the resulting movement from "relationship" to "price" (i.e., competitive) banking seems certain to continue. For example, the current enormous and unsustainable trade imbalance between the United States and Japan generates irresistible pressures to recycle capital outside the traditional national economies. This poses important questions not only about the future stability of both countries' financial systems but also about the efficiency of the Japanese financial system in adjusting to further erosion of relationship finance. This is especially true given the powerful and pervasive place of relationships throughout Japanese society.

FISCAL POLICY AND BUSINESS-GOVERNMENT RELATIONS

by

Michael G. Rukstad

This chapter comparatively assesses the effects of fiscal policy on market demand and business costs in Japan and the United States. The largest differences in the effects of fiscal policy have been on business costs, particularly those resulting from the government deficits in recent years and the selective tax measures in the early postwar years.

The Japanese fiscal policymaking cycle is relatively short, centralized in and largely controlled by the Ministry of Finance, procedurally limited by informal rules constraining fiscal outcomes, and characterized by incremental change. The American process, on the other hand, is longer, largely decentralized among various executive agencies and Congressional committees, subject to extensive interest-group pressures, governed by procedures specifying fiscal process, and more open to new budgetary initiatives, particularly from the president.

After World War II, both countries were slow to adopt fiscal policy as a means of controlling the fluctuations in market demand resulting from business cycles. By the mid-sixties, both countries changed from a passive to an active fiscal policy, but for different reasons. The Japanese Ministry of Finance maintained its control over the budgetary process by responding to the economic crisis of recession and imminent bankruptcies, whereas the U.S. president asserted fiscal leadership in responding to the chronic slow growth of the 1950s and early 1960s. The similarity in the response continued in the aftermath of the first oil shock, when both countries adopted stimulative policies to overcome the severe recessions that affected all oil-importing nations.

Only since the 1980s has fiscal policy significantly differed in both direction and rationale. Once again, the Ministry of Finance asserted its control by focusing on the reduction of fiscal deficits in order to prevent additional problems associated with their continued financing. Under President Reagan's supply-side tax policies, the rhetoric of fiscal goals has shifted to a concern for business costs, rather than managing aggregate demand. But the reality of cost reduction has not yet followed because the deficits threaten to offset any cost reductions achieved by corporate tax cuts.

Deficits appear to have played a much larger role in forcing up real interest rates in the U.S. than in Japan, because of the lower U.S. savings rate. This, in turn, contributed to the dramatic appreciation of the dollar and the loss of price competitiveness by U.S. firms during the period 1980-85. The dollar's depreciation against the yen, which began late in 1985, has not yet had any powerful effect on the trade deficit. Although the macroeconomic effect of fiscal deficits on the economy has been less in Japan than in the U.S., ironically, the institutional pressures to reduce the deficit have actually been greater. One consequence has been the reduction of selective tax measures for business in Japan in order to reduce the deficit, at a time when the number of U.S. selective tax measures has been rising. Although many such incentives have disappeared in Japan, the Japanese have not abandoned all methods of channelling resources.

While American deficits are trending higher, Japanese deficits, under the careful management of the Ministry of Finance are declining. Without leadership from some quarter in the U.S., especially the president, it is unlikely that the American institutional system will respond on its own accord to the deficit problem.

MANAGING RETREAT:

DISINVESTMENT POLICY IN THE UNITED STATES AND JAPAN

by

Douglas D. Anderson

Disinvestment, the process of removing resources from a business or an industry which is no longer competitive, is probably the most painful task any economy faces. The problem is especially difficult when, as was the case in both the United States and Japan during the 1970s, the overall rate of growth in the economy slows, and resources which are freed up from one activity experience difficulty moving to new uses.

As difficult as it is, the disinvestment process is central to economic growth. For that reason both private and public decision makers have a vital interest in understanding and improving the process whereby labor and capital are extracted from slow-growth (or declining) industries.

Whereas in the United States the government has characteristically adopted a "hands-off" approach to dealing with such questions, in Japan, the government has developed a "hands-on" approach to managing industrial retreat. These institutional relationships have been widely praised by industrial policy advocates in the United States. This chapter investigates the operation of recession and depression cartels in Japan and seeks to compare their effect with the less intentionally organized methods of dealing with structural decline in industries in the United States.

The chapter concludes that Japan is indeed better at "hands-on" disinvestment management than the U.S., but cautions that this is not an endorsement for adopting such an approach in the United States.

As the evidence reviewed in this chapter demonstrates, industrial restructuring -- whether in Japan, the United States, or any other country -- is easier to accomplish when the overall economy is rapidly growing than when it is not. Thus, those who argue that Japan's disinvestment record has proved superior to that of the United States may be ascribing to microeconomic institutions behavior that is more appropriately related to the country's macroeconomic performance. To put it another way, the story of Japanese success and American failure in enhancing productivity and competitiveness cannot be related primarily to the skill of Japanese companies or the ineptitude of American ones in divesting, shrinking, or shifting out of moribund enterprises. Nor did Japan's macroeconomic achievements -- impressive though they were -- derive chiefly from a unique national ability to restructure declining industries. Instead, the effectiveness with which the Japanese government was able to formulate and implement capacity-reduction schemes varied, depending on structural characteristics of the individual industries.

AMERICA VERSUS JAPAN: CONCLUSIONS AND IMPLICATIONS

by

Thomas K. McCraw

Conclusions

1. The Two Countries Have Exhibited Different Conceptions of the Relationship Between Domestic and Global Markets. From the Japanese viewpoint, the fundamental importance of a few basic areas of production such as steel ("the rice of industry") dictated that a modern economy must invest there. Within the export-oriented setting of Japan, the potential for scale economies in those same industries propelled them into competition for world markets. In American public policy toward production, the idea of globalism dawned relatively late--not so much for individual companies, American multinationals having been pioneers in global markets even in the nineteenth century, as for formal national competition policy.

2. The Japanese Implicitly Tend to View Transactions as Continuous, the Americans as Ad Hoc. In Japan, government bureaucrats and business executives have long regarded economic activity as an endless continuum. No single transaction, in either the economic or the regulatory sphere, can be considered autonomous and self-contained.

The American system, in contrast, is characterized by thousands of separable *ad hoc* transactions. *Caveat emptor* remains the governing rule, in a way that would be unthinkable in Japan.

3. The Number of Important Decision Makers Tends to Be Smaller in Japan than in the United States. As the chapters on trade, agriculture, energy, the environment, fiscal policy, and disinvestment all make clear, important public policies in Japan usually are made by fewer persons than in America.

4. Domestic Politics Profoundly Shapes Economic Policies in Both Countries. Rigorous rationalization of wholesale and retail trade would have played havoc with local Japanese customs. It might well have thrown several hundred thousand persons out of work. Similarly, a rapid and forced agricultural adjustment, whatever the economic benefits to Japanese consumers as a whole, would have disrupted the housing and income patterns of millions of Japanese families.

The most powerful evidence of political influence on American economic policy appeared in the prolonged failure of the United States to deal in a rational way with the federal deficit, and especially with the relationship of this deficit to the workings of the international economy. Because of the Americans' steadfast refusal to address the deficit problem realistically, much of the blame for the recent deterioration in American-Japanese relations, though by no means all of it, must lie at the door of the United States.

5. In Its Public Policies, Japan Has Viewed Countries Primarily as Economic Competitors, While the United States Has Regarded Them Primarily as Geopolitical Entities.

6. Japan's Public Policies Have Emphasized Producer Values; Those of the United States, Consumer Values. Historically, the Japanese have taken their texts from the leading theorists of production-oriented economic nationalism--writers such as Friedrich List, the German apostle of nationalism.

In the United States, the reigning ideologies have been mixed, but are best typified in the writings of three other theorists: Thomas Jefferson, who argued that the best government governs least; Adam Smith, whose invisible hand, unfettered by government regulation, moves automatically to promote the public interest; and, for international economics, David Ricardo, who showed how free trade, based on each country's comparative advantage in physical endowments, would maximize the world's wealth.

Implications

1. Because of the Continuing Consumerist Orientation of the United States, the American Deficit Situation Will Become Worse Before It Becomes Better, and Japanese-American Relations Will Therefore Continue to Show Strain.

To rectify its unsustainable fiscal situation, the American government would have to reduce the deficit, stop relying so heavily on foreign borrowing, and promote improved industrial productivity and exports. By the middle 1980s, these goals had become so obvious that practically no knowledgeable person in the United States could disagree with them. Yet a political gridlock has persisted throughout the middle 1980s. The president continues to insist on a combination of low taxes and immense military expenditures. Meanwhile, both he and Congress habitually shy away from cuts in other big budget items, such as social security entitlements. All of these actions confirm the consumerist orientation that has long characterized the American political economy.

2. Significant Changes in Japanese Policies--as in American Ones--Will Be Essential to Preserve the Japanese-American Friendship and a Healthy World Economy. Just as the consumer-driven American economy has become a machine for sucking in imports, so the producer-oriented Japanese system is designed specially to push out vast quantities of exports. These characteristics of both countries, remain deeply embedded in their cultures. As every chaprer of this book testifies, these same characteristics are built into the very structure of business-government relations. Thus, in Japan as in America, change will be difficult to accomplish. Inevitably it will be accompanied by pain for some segments of the Japanese population.

In suggesting that the Americans should move more rapidly toward producerist values and the Japanese toward consumerist ones, we do not mean to argue naively that the two countries must converge into some hybrid and become indistinguishable from each other. But we do believe that if no significant changes are made, then serious consequences lie ahead: rising international protectionism, the gradual closing of markets for Japanese exports, and, in the end, a trade war directed specifically against Japan. All of this would be a great pity, because in the last analysis the Japanese-American friendship represents a pearl beyond price--a hard-won achievement far too valuable to place in jeopardy merely because of short-term political inertia.

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Mr. **Behr**. Thank you very much.

Professor McCraw has told us in summing up briefly that, first of all, we cannot, in his opinion, grow our way out of the trade deficit that we face. This is a deficit that's financed from abroad and it's putting more and more dollars into foreign hands, adding to the instability that threatens the economic well-being not only of Americans but of the entire world.

We are faced with a debate about whether the root cause of this is structural, having to do with the consuming nature of the United States and the exporting nature of Japan, or whether it's fundamentally a macroeconomic policy having to do with exchange rates and budget deficits, the cause of which lies here in this town.

To shed light on that question and other aspects of this debate, we are going to turn to Prof. Hugh Patrick, professor of international business and director, Center on Japanese Economy and Business, at the Graduate School of Business at Columbia University, an authority on the Japanese economy for the past 30 years.

STATEMENT OF HUGH PATRICK, R.D. CALKINS PROFESSOR OF INTERNATIONAL BUSINESS, AND DIRECTOR, CENTER ON JAPANESE ECONOMY AND BUSINESS, GRADUATE SCHOOL OF BUSINESS, COLUMBIA UNIVERSITY

Mr. **Patrick**. Thank you very much. I welcome these hearings which focus both on the United States-Japan relationship and in a broader context on United States relations with the economies of the Pacific Basin as well.

In addition to my Japan hat, I might mention that I am a member of the U.S. National Committee for Pacific Economic Cooperation and attended the meeting in Vancouver last month of the fifth Pacific Ecomomic Cooperation conference.

I am delighted to be with this group of panelists and expect to learn from it. I am particularly glad that Professor Ichimura, who is our first distinguished visiting professor at the Center on Japanese Economy and Business at Columbia, is with us today. He is a very independent-minded guy, and we have not colluded in the preparation of our respective testimonies.

I have submitted for the record a previously published paper titled "The Burgeoning American Economic Stake in the Pacific Basin," in which I raise a number of issues dealing with Japan and with the Basin more broadly.

In this oral presentation I focus on the Japanese economy domestically, in terms of the bilateral relationship with the United States, and also in the broader contexts both of the Pacific Basin and of the respective leadership roles of our two countries in the world economic system.

Let me summarize my main point starting with Japan's domestic economic prospects. Underlying my analysis is an assumption that the price of oil will not rise significantly within the time horizon of my discussion. I also expect that the yen will continue to be a strong currency. My time horizon is accordingly somewhat shorter than the year 2000 because I would not be surprised if sometime in the 1990's we have another sharp rise in oil prices, though not sooner.

To summarize, first, while the longer run growth prospects for the Japanese economy are good, I expect Japan's economic growth performance for the next 1 to 3 years to be mediocre or worse, essentially due to deficient demand.

Second, I anticipate that Japan will continue to generate very large surpluses of domestic savings over private domestic investment and government budget deficits, not just in the next few years but over the longer term.

Therefore, third, I expect Japan to continue of run a substantial current account surplus with the rest of the world. However, it will be reduced considerably as a share of GNP, with a structural surplus averaging on the order of 1 to 2 percent of GNP over the coming decade or so. Nonetheless, that will be a very large number.

Fourth, Japan, as a consequence, will continue to be a very large net portfolio capital exporter as well as an increasingly important financial intermediary in world financial markets, borrowing short term and lending long term. As long as U.S. interest rates remain high in real terms and we continue to generate ever-increasing supplies of United States Government securities, then much Japanese capital is likely to continue to be attracted to United States financial instruments.

Fifth, while the Japanese domestic economy will not be doing so well in the near-term future, there are many dynamic, vigorous, flexible, technologically sophisticated Japanese firms. They will be seeking markets and will become increasingly involved in direct investment activities abroad, particularly in the United States and Europe. With limited domestic growth and profit opportunities at home and since exports will be less profitable because of a continuing high exchange rate, these firms will increasingly produce abroad.

The United States-Japan economic relationship has been marred and indeed threatened by ever-heightening frictions, both macroeconomic and micro or structural.

We need to address these issues constructively while recognizing that our relationship is not only huge but increasingly complex because it involves two-way flows not only of goods and services but of capital and technology. These flows are of immense benefit to the citizens of both countries and to most of the businesses in both our nations.

These bilateral relationships are generating a lot of business and a lot of profits; when we think about the frictions we also need to remember all the benefits we both obtain from this bilateral relationship.

Let me make several general points. First, it is essential to distinguish between the macroeconomic problem of the huge United States global trade deficit and Japan's global surplus and, along with that, the huge bilateral deficit in United States trade with Japan, and the microeconomic or structural problems of market access due to the remaining trade barriers in the Japanese economy.

Make no mistake; the U.S. trade deficit is essentially a consequence of the size and mixture of U.S. macroeconomic policies, our high interest rates, our large budget deficits, the fact that as an economy the United States spends more than it produces and imports the difference and borrows to finance those imports.

While existing trade barriers in Japan and other Pacific Basin economies are significant in their own right and need to be addressed, they are neither the cause of the U.S. overall trade deficit nor the major source of its solution.

After all, the Asian Pacific economics have not become more protectionist in the last 5 years, while the U.S. current account deficit has become intolerably large. My colleague has quoted one American source of great truthfulness. I'll quote another, Pogo, who said, "I have met the enemy and he is us."

While the solution of the U.S. balance-of-payments problem rests primarily in America, including both the congressional and executive branches, there are policies that Japan, other Pacific Basin economices, and indeed Western Europe and other economies as well can and should pursue which will alleviate the adjustment process both for the United States and for themselves.

The problem with the Japanese economy in terms of market access is not that it is completely closed, as is sometimes mistakenly alleged, nor that it is completely open as some Japanese like to assert; but the trade barriers remain high in significant sectors and products in which Japan has competitive disadvantages vis-a-vis the United States or many of the other Asian Pacific economies.

It's not the general closedness, but the lack of market access in a number of important specific markets that is our ongoing issue vis-a-vis Japan. And the list is long. It ranges from agriculture and processed foods, plywood, cigarettes, chocolates, to satellites, military aircraft. It goes on and on.

It is important that Japan reduce those barriers both for the sake of its own consumers and taxpayers and for its relationships with the United States and other nations. That is quite independent of any effect on the global or bilateral trade surplus of Japan or trade deficit of the United States.

Indeed, the United States-Japan economic relationship should not be viewed just bilaterally but in a much more comprehensive context, in part that of the Pacific Basin region as we are discussing in this symposium, but especially in the respective roles of the United States and Japan as global leaders in the international economic system.

The fact of the matter is that whether Japan wants it or not, leadership is being placed upon it in a number of important economic areas simply by the virture of Japan's sheer economic size, economic presence in the world economy, and huge and continuing current account surpluses and capital outflows.

The Untied States and Japan face two common problems of overwhelming importance for their own domestic well-being, for the bilateral relationship, and indeed for the world economy.

One if to prevent protectionism in either country. It is essential to maintain an open multilateral international economic system. The United States must resist strong domestic pressures to raise more and more ad hoc import barriers and indeed should roll back those that have been imposed.

Japan, as a global leader, has an obligation to open its markets further, particularly in areas where remaining trade barriers are significant.

These are key requirements for these two global leaders.

Second, each country must resolve the huge problems created domestically and internationally by their respective current account deficit and surplus. The U.S. trade deficit in particular cannot be allowed to continue. A decline in the value of the dollar and a rise in the value of the yen has stopped the trend of increasing United States global deficits and increasing Japanese surpluses. Moreover, they will soon lead to a substantial decline in the bilateral trade deficit of the United States with Japan. This has already shown up in volume or quantity terms and is just beginning to show up in the reduction in the dollar value of the trade imbalance.

I anticipate that in the months ahead there will be a decline in both global and bilateral deficits in the United States. But that is going to be a slow and long-run process, not something that will happen quickly and indeed probably should not happen quickly if we want to have the world economy avoid recession.

Obviously, in longer run perspective it is essential that the new round of GATT negotiations be strongly supported by both the Japanese and American Governments, including our respective legislatures, so that we move forward rather than backward in the maintenance of an effective international economic system that is open and fair to all.

On the U.S. side, we have to change our policy mix in order to reduce real interest rates and to enhance private investment and private savings, while reducing the Government share of total resource use in the economy. That is to say, we must reduce the budget deficit.

I anticipate and would welcome a further decrease in the trade-weighted exchange rate value of the dollar. Incidentally, that does not mean that the yen necessarily has to appreciate further against the dollar because there are a whole host of other currencies with which the adjustment has not yet occurred. However, in the longer run I expect that the yen will continue to appreciate relative to the dollar.

In the shorter run, Japan must alter its macroeconomic policy and create a more dynamic domestic-based growth such as the Maekawa Report proposes. The appears likely during the course of the next year or 2.

The case for sustained good growth of the Japanese economy is essentially a domestic one. Foreign countries cannot dictate how fast a domestic economy can or should grow. Nonetheless, the danger is real that Japan wlll grow very poorly in the coming quarters because of the effects of yen appreciation and the lack of private domestic demand.

Japanese exports will decrease in volume and yen value terms. Nonoil imports will increase, and the net foreign trade contribution to Japanese growth will be negative. Indeed, that is already the situation.

Frankly, I doubt that domestic demand growth, even with some shift in Government policies toward moderate stimulus, will be sufficient to achieve a growth rate of more than 2 percent a year in the next year or 2.

The greatest losers from slow Japanese growth are the Japanese people themselves. The second greatest loser is the world economy which depends on the growth of import demand from the United States, Japan, and Europe as the stimulus for world progress.

With the United States sources of that stimulus inevitably declining as our trade deficit begins to narrow rather than continuing to widen, then Japan, with Germany and others, must pick up the slack if the world economy is not to stagnate.

Japan has a strong vested interest not just in participating in but helping create a prosperous world economy because the consequences, including the breakdown of the open market trading system which would retreat into protectionism are so costly and harmful.

Thus far, the direct effect of more rapid Japanese growth on the U.S. balance of payments is quite modest. The more important impact, both for the Japanese people themselves and for the world economy, constitute the strong case for new demand stimulus by the Japanese Government.

My pessimism about Japanese growth in the near term lies in my concern that the Government lacks the political will to shift its priorities even temporarily away from its current commitment to budget deficit reduction or to switch policies far enough or fast enough unless major domestic economic problems emerge in Japan such as virtually zero growth, sharply rising unemployment, and the bankruptcy of many small firms.

It may well take that to force the Government to shift its policies sufficiently dramatically to provide adequate domestic stimulus. Short of that, I see the Government muddling along and the Japanese economy muddling along as well for much of the rest of this decade.

Thus, I suppose I am a short-run pessimist about the Japanese economy while being a long-run optimist. On the other hand, the United States has muddled along for some years now, so perhaps we should not be surprised if the Japanese do so, too.

[The paper referred to follows:]

THE BURGEONING AMERICAN STAKE IN THE PACIFIC BASIN

By

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Background Paper for

Joint Economic Committee

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The Burgeoning American Economic Stake in the Pacific Basin

HUGH PATRICK

The United States economic stake in the Pacific basin lies both in the economic opportunities and challenges the dynamic region provides and in their implications for the formulation of American foreign economic policy. The extensive, and fundamentally beneficial, economic significance of the region for the United States is reflected in eight propositions:

1. The American economy is now more involved in the world economy than ever before in its history, not only absolutely but also relative to its total production, investment, and consumption. Over the past two decades the share of exports plus imports of goods and services has virtually doubled to more than one-fifth of the United States gross national product.[1]
2. United States trade with the Pacific basin economies has become greater than with any other region of the world, replacing Western Europe. For more than a decade, a larger amount of American trade has flowed across the Pacific than the Atlantic.
3. While the United States economic relationship with the Pacific basin has been founded overwhelmingly on merchandise trade, it is becoming increasingly diversified and complex. It involves an ever-wider range of services, especially American financial institutions' trade and project financing and other financial services, American multinational corporations' direct investments in specific projects, and many forms of technology transfer.
4. At least until the end of the century, the United States economic interaction with the Pacific basin will continue to grow more rapidly than with any other region of the world. The Pacific basin economies on average will probably grow more rapidly and pursue outward, trade-oriented development and growth strategies even more than over the past two decades.
5. The dynamic expansion of Pacific basin exports to American markets has created severe competitive difficulties for a number of American industries. This expansion, combined with other factors, has led to a sharp increase in the expres-

sion of protectionist sentiments, especially within Congress. The Pacific basin economies have become the major catalyst in shaping the current United States trade policy debate.

6. Japan is predominant in the United States's Pacific basin economic relationship because of its huge economic size, technological sophistication, combined role as the United States's largest overseas trading partner and rival, major participant in world financial markets, and actual and especially potential leadership role with the United States and Western Europe in maintaining the international economic system. More than any other single nation, Japan has become the lightening rod of American concerns over trade policy and the problems of the international economic system.

7. The United States is now running intolerably large and ultimately unsustainable global and Pacific basin regional trade and current-account deficits. While the region's economies are the source of more than half of the United States trade deficit, they are more symptom rather than cause of the United States balance-of-payments problems. Those causes lie predominantly in United States macroeconomic policies, economic performance, and economic behavior that have resulted in high interest rates, an overvalued dollar, and huge capital inflows financing the excess of imports over exports.

8. Over the past decade, the Pacific basin economies have become increasingly open and have been the major world region engaging in trade liberalization. American exports to the Pacific basin have increased more rapidly than to any other part of the world. However, liberalization has proceeded from initial high levels of import protection in almost all of the region's economies, and significant trade and other market access barriers persist.

The "Pacific basin" is defined here somewhat narrowly in order to focus on the United States relationship with the Western Pacific economies. Although Canada is by far the United States's largest single economic partner, it is excluded because that relationship is founded on continental trade across a long common border.

The Growing Trade Relationship

Table 1 provides an overview of the development of United States trade with the Pacific basin economies over the past fifteen years. Several patterns stand out.

Between 1970 and 1980 the Pacific basin share of United States exports and imports remained approximately constant, despite the sharp increase in oil prices that shifted United States and Pacific basin regional trade patterns toward the Middle East and away from other parts of the world. Since 1977 the relative share of Western Europe declined, and as a consequence of greater regional diversification United States trade with the Pacific basin has been greater than with any other region of the world.

Since 1980 the share of the Pacific basin in United States trade has risen sharply, from a fifth to a quarter of United States exports, and from a quarter to a third of United States imports. This recent spurt is in part a consequence of the same forces that have impelled United States trade to the region all along: faster growth

TABLE 1

United States Merchandise Exports to and Imports from Pacific Basin Economies
(Customs basis, millions of dollars)

	1984			1980			1970		
	Exports	*Imports*	*Trade Balance*	*Exports*	*Imports*	*Trade Balance*	*Exports*	*Imports*	*Trade Balance*
Japan	$ 23,575	$ 57,135	$ −33,560	$ 20,790	$ 30,701	$ −9,911	$ 4,652	$ 5,875	$ −1,223
Asian-Pacific Developing Market Economies[a]	23,729	48,646	−24,918	20,988	28,363	−7,375	3,097	2,991	106
Australia and Oceania[b]	5,746	3,558	2,187	4,876	3,392	1,484	1,188	871	317
Market Economies: Subtotal (A)[c]	53,048	109,339	−56,291	46,653	62,456	−15,803	8,937	9,737	−800
China	3,004	3,065	−61	1.1	–	1.1	–	–	
Total (B)	56,052	112,404	−56,352	46,655	62,456	−15,802	8,937	9,737	−800
U.S. World Trade (C)	217,880	325,728	−107,848	222,705	240,834	−18,129	43,226	39,963	3,263
A/C	24.3%	33.6%	52.2%	20.9%	25.9%		20.7%	24.4%	
B/C	25.7%	34.5%	52.3%	20.9%	25.9%		20.7%	24.4%	

Source: U.S. Department of Commerce, Bureau of the Census, *Highlights of US Export and Import Trade* (FT 990), December 1984, December 1980, December 1970.

[a] Classified as "Asia, n.e.c.," excluding Laos and Kampuchea. The main economies included are South Korea, Taiwan, Hong Kong, the Philippines, Indonesia, Malaysia, Thailand, and Singapore.

[b] New Zealand is a distant second to Australia; trade with South Pacific island economies is small.

[c] Canada and Latin America are excluded.

of the region's economies than those of the rest of the world, rising demand for American capital goods and high-technology products, and the export-oriented industrialization policy pursued by a number of the Pacific basin economies. In part, it reflects special factors of the past five years, notably the poor Western European economic performance and the severe Latin American debt problem. Major Latin American economies have had to pursue stringent austerity programs, which contributed to a decrease of some 40 percent in United States exports to the region since their debt problems began in 1982. Nonetheless, the recent sharp rise in United States imports from the Pacific basin is a consequence of the region's now large, still increasing, and more diversified industrial export capacity combined with the overvalued dollar exchange rate.

The United States global deficit has risen sharply since 1980, and more than half of it is with the Pacific basin. Imports surged into the United States in 1984 most rapidly from the Pacific basin (33 percent growth), Western Europe (32 percent), and Canada (28 percent). While the Pacific basin's relative share of the United States trade deficit declined by almost 5 percentage points, the absolute increase by $24 billion to $56 billion has contributed significantly to galvanizing American policymaker concerns.

The dynamic growth and great heterogeneity of the Pacific basin region are discussed in other essays in this volume (see especially Drysdale and Okita). Nonetheless, it is important to emphasize here the immense differences among the Pacific basin economies in their level of development, rate of growth, economic size, natural-resource endowment relative to population, type of economic system, and degree of domestic involvement in foreign trade. These differences are the source of different patterns of comparative advantage vis-à-vis the United States and one another, and hence the mixture of complementary and competitive economic relationships. United States economic interests are directly related to two variables: (1) American trade, not surprisingly, is mainly with the larger, rapidly growing, industrial-market economies that engage in substantial trade; and (2) American direct investment and financial loans go not only to these economies but also to resource-rich Australia and Indonesia for natural resource projects.

The classification in table 1 reflects part of these differences. Resource-poor Japan and resource-rich Australia and New Zealand are advanced, high-income economies. Two economies, Japan and China, are far larger than the others in total production, but their respective relationships with the United States are vastly different. Japan, unlike China, has a highly developed, market-oriented, industrial economy that is a full participant in the world economy. United States economic involvement with China has expanded rapidly since 1980; the potential is substantial, but the actual level is still relatively modest; and trade, investment, and technology transfer issues are unique. American economic involvement with other Asian-Pacific Communist nations (North Korea, Vietnam, Kampuchea, and Laos) is negligible and will remain so for the foreseeable future.

The Asian-Pacific developing-market economies consist primarily of two major groups: the rapidly industrializing, resource-poor economies of South Korea, Taiwan, Hong Kong, and Singapore (the so-called four Asian NICs, or newly industrializing countries); and the resource-rich economies, mainly Indonesia, Malaysia, Thailand, and the Philippines (the "Resource-Rich Four").[3] Not surprisingly, United States economic interests in the much smaller developing economies of Southeast Asia and the South Pacific are limited, primarily to specific natural-resource-based activities.

The commodity composition and specific geographic pattern of United States trade with the Pacific Basin reflect these conditions. The United States's competitive (comparative) advantage lies in industrial machinery and high-technology goods and services, and in agriculture and certain other natural-resource-based commodities, including processed minerals, such as aluminum. Accordingly, the United States exports high technology and capital-intensive resource-based manufactures to all the Pacific basin economies, and agricultural products to resource-poor Japan (the largest national market for United States agricultural exports) and the Asian NICs.

American imports from the Pacific basin are overwhelmingly manufactured goods, together with a modest amount of crude oil ($4.7 billion in 1984, 8 percent of total oil imports), mainly from Indonesia. Imports include a wide range of industrial products from Japan, especially automobiles (32 percent of all Japanese exports to the United States in 1984), consumer electronics (15 percent), office equipment and computers (9 percent), and steel (6 percent). The Asian-Pacific developing market economies and China export mostly labor-intensive products to the United States – notably clothing (18 percent) and other textiles, footwear, and relatively simple consumer electronics and electrical components. As the four Asian NICs move up the technology ladder they are expanding their exports of relatively more sophisticated products, ranging from simple steel products to video cassette recorders and competing directly with Japanese companies in the American market. Concomitantly, the resource-rich Southeast Asian economies are well into the industrialization process and are placing greater emphasis on manufactured exports. Not surprisingly, these include garments and other labor-intensive textiles as well as relatively simple, labor-intensive products, such as electronics and watch assembly, by subsidiaries of American and Japanese companies.

Throughout the post-World War II period, Japan has been – by far – the United States's most important bilateral economic partner in the Pacific basin. This is the case by all standard economic criteria – two-way trade, investment, technology licensing, and other modes of transfer. What was initially a small and relatively simple economic relationship has become much larger, multidimensional, more complex, and much more difficult to manage well. Japanese firms in many industries have become highly effective competitors of their American counterparts, not just in the Japanese and American markets but in other Pacific basin markets as well. More fundamentally, Japan plays a special policy role (whether it wishes to or not) by its very economic size, prosperity, current growth rate, and now large and still rising trade surplus. Japan is expected by others, and its government and has agreed in principle, to play a major role in the maintenance of the international economic system by opening its trade and financial markets as well as providing large amounts of economic aid to developing countries. However, Japan's rate of progress in providing market access has been frustratingly slow for all its trading partners, especially the United States and the Asia-Pacific developing-market economies.

While the Japanese presence has been well noted, United States trade with the Asian-Pacific developing market economies has been equally rapid and, in aggregate, of comparable size. (See table 1.) This trade growth, especially in the share of American exports and imports, has been most pronounced with the NIC-4 economies as they have industrialized and grown rapidly. This is well demonstrated by the data in table 2. By 1984, the NIC-4 accounted for three-quarters of United States exports to, imports from, and trade deficit with the Asian-Pacific developing market economies.

While the NIC-4 have significant economic characteristics in common, each has its own special policy relationship with the United States. Taiwan and South Korea are economically similar, as are Hong Kong and Singapore. American trade, as well as the trade deficit, has been greater with South Korea and especially Taiwan. United States bilateral trade with Taiwan is still three times that with China, and it increased by substantially more in the 1980–84 period of developing United States-China trade relations. Imports from Taiwan have dominated the bilateral trade, especially in 1984 when Taiwan's total exports expanded explosively. Hong Kong and Singapore have the special features of being small city-states with high per

TABLE 2

Growth in Share of Major Pacific Basin Economies in United States Total Merchandise Trade (in percent)

	United States Exports to			
	1960	*1970*	*1980*	*1984*
Japan	7	11	10	11
Four NICs[a]	2	4	7	8
Resource-Rich Four[b]	3	2	3	3
Total	14	17	20	22
	United States Imports from			
	1960	*1970*	*1980*	*1984*
Japan	7	16	13	18
Four NICs[a]	2	5	8	11
Resource-Rich Four[b]	4	2	4	4
Total	13	23	25	33

Sources: Patrick, cited in footnote 2; U.S. Department of Commerce, *Highlights* (December 1984), cited in footnote 1.

[a] Korea, Taiwan, Hong Kong, and Singapore.

[b] Indonesia, Malaysia, Philippines, and Thailand.

capita incomes (above Spain and roughly comparable to Italy). They are the most open economies in the world, with continuing enterpôt trade (which somewhat distorts the data on ultimate sources and destinations of United States trade with their neighbors), and are highly developed regional money-market and financial centers in which American banks actively participate.

The Widening Scope of Economic Involvement

While foreign trade can stand on its own, American commercial banks have typically provided the short-term financing of exports and imports. In practice, they have also extended substantial amounts in loans to businesses, banks, and governments in addition to trade finance. Direct investment by American companies in production activities has become increasingly related to and promotive of trade. Data on American companies' direct investment and commercial-bank loans to the major Pacific basin economies are provided in table 3. It should be noted, however, that data on direct investment, technology, and financial flows are less comprehensive and reliable than trade statistics and are not designed for intercountry comparisons.

American companies invest in Pacific basin production activities for a variety of industry-specific reasons: to develop natural resources, to obtain access to local markets, or to take advantage of cheap labor costs in producing parts and components. Direct investment involves the flow of American capital, managerial know-how, and production technology to the region's economies. Component parts are often exported for local production and assembly, as are related products to round out a product line in marketing in the local economy. Increasingly, American manufacturing multinationals are using the Pacific basin as an important element of their global strategy for producing low-cost parts, components, or even simpler final products. Thus a significant proportion of trade is between various subsidiaries of the same multinational corporation rather than arm's length transactions between independent parties. Similar patterns exist for Japan, the other major foreign direct investor in the region.

The single largest national recipient of American business investment in the region is Australia. It is mainly in minerals for exports, particularly to the region's resource-deficient economies. American companies also produce cars and other manufactures for the Australian market. American direct investment in Japan, the second largest recipient, is predominantly in manufacturing for that market, with exports going mainly to other Pacific basin countries. The main exception is American automobile producers, which obtain subcompacts for the American market from Japanese companies in which they have a minority ownership share.

In contrast, about one-third of American-owned manufacturing in Asian-Pacific developing market economies is exported to the United States, and about two-fifths is sold in the domestic market.[3] These export ratios are considerably higher for American investment in Singapore, Hong Kong, Malaysia, Taiwan, and South Korea. About one-fifth of all United States imports from Asian-Pacific developing-market economies emanates from American affiliates abroad. A substantial part is trade in crude oil and in other natural resources. The ratio for manufacturing imports in 1976, the latest year for which evidence is available, was only 5 percent. That was far below the world average for American multinational manufacturers that engage in extensive intracompany specialization and cross-trade with their European subsidiaries. This phenomenon appears to have developed rapidly in the Pacific basin region during the past decade.

The United States financial involvement in the Pacific basin is large, diverse, difficult to sort out clearly, and on the whole relatively safe. Having pursued different policies, the Pacific basin countries have not been a significant element in the Third World debt problem that has so hurt Latin America. If anything, it has become relatively more attractive to lend to many of them. At the macro level, absolutely and relative to their debt-servicing capacity, the amount of foreign debt owed is high in only two countries, South Korea with about $45 billion and the Philippines with about $26 billion. Korea has managed its debt well thus far. The Philippines continues to pose a serious risk as its ongoing political crisis magnifies underlying economic difficulties.

Table 3 provides an important though only partial indicator of American financial involvement. United States commercial-bank loans to Pacific basin economies are large by any measure, more than double American business direct investment. Financing involves many channels, a variety of institutional arrangements, and many ways of distributing various kinds of risk. For example, the adjusted country amounts reported in table 3 are significantly larger for Japan because overseas offices of Japanese banks are big borrowers; in contrast, Hong Kong and especially Singapore, as money market centers, book many United States bank loans that are guaranteed by banks of other countries.

But United States commercial-bank lending to the Pacific basin is by no means the entire story. American sellers of capital goods to the region provide long-term suppliers credits, on occasion packaged with loans from the United States Export-Import Bank. American institutional portfolio investors (such as pension funds, mutual funds, and life insurance companies) as well as some individuals have been purchasing increasing amounts of bonds and stocks issued by countries and companies in the Pacific basin, mainly Japanese. Much funding is done through the Eurocurrency markets; the recipient may be ascertainable, but the ultimate source of such funds is difficult to detect.

On a gross basis, American short- and long-term credits to the Pacific basin economies have grown rapidly, but in the past several years there has been an increasing net inflow to the United States from the Pacific basin. In other words, the financial relationship has not only become much larger, but it has also become two-way, to a degree that the gross outflows from the Pacific basin economies have apparently become even greater than the inflows.

The most important force at work has been the overwhelming global and regional United States balance of payments current-account deficit that must be financed by equal amounts of net capital inflows from somewhere, though not

TABLE 3

United States Companies' Direct Investment and Commercial Bank Lending in the Pacific Basin
(millions of dollars)

	Direct Investment Outstanding (December 1983)	*Commercial Bank Loans Outstanding*[a] *(end March 1985)*	*Commercial Bank Loans Outstanding Adjusted*[b] *(end March 1985)*
Japan	$ 8,059	$ 16,821	$ 46,738
Developing market economies	12,715	41,187	33,558
South Korea	650	10,344	11,141
Taiwan	695	2,825	3,143
Hong Kong	3,310	7,008	3,865
Singapore	1,965	7,223	1,607
Indonesia	3,042	3,331	3,092
Malaysia	1,118	1,761	1,936
Philippines	1,102	5,369	5,125
Thailand	729	2,138	2,488
Australia	8,627	6,032	8,073
New Zealand	578	958	1,060
Subtotal	29,979	64,998	89,427
China	−9	808	1,237
Total (A)	29,970	65,806	90,664
United States world total (B)	226,117	320,856	330,830
A/B	13.3%	20.5%	27.0%

Sources: U.S. Department of Commerce, *Survey of Current Business*, November, 1984; Board of Governors of the Federal Reserve System, Federal Financial Institutions Examination Council, Statistical Release E.16 (126) (County Exposure Lending Survey, March 1985), 26 July 1985.

[a] Cross-border and nonlocal currency lending by country of borrower's residence.

[b] Adjusted to exclude loans guaranteed by residents of other countries and to include loans to other countries guaranteed by nonbanks in the reported country, plus borrowings by foreign offices of reported country's banks.

necessarily the Pacific basin. The second major factor is Japan, which has become a major capital exporter to the United States, net as well as gross. High domestic saving and a large current-account surplus provide the basis for rising net capital outflows approaching $50 billion annually in 1985. Financial liberalization has made possible a surge of Japanese institutional pent-up demand for United States bonds. Equally significant, major Japanese commercial banks are vigorously participating in international financial markets as borrowers and lenders. Japanese banks' outstanding foreign loans even slightly exceeded those of American banks by the end of 1984 ($378 billion versus $373 billion, net of interoffice loans).[4] Rather quietly, Japan has become a major international financial intermediary, borrowing short and lending long. Japan's estimated net international asset position is now the largest in the world. United States statistics indicate a shift from net creditor to debtor position in 1985 as the huge current-account deficit persists, but the asset position is substantially underestimated, since the $233 billion in American direct foreign investment is measured at book rather than market value.

Other forces also attract Pacific basin financial capital to the United States. High nominal and real interest rates on very safe United States government securities attract funds from everywhere. Pacific basin governments hold most of their foreign exchange reserves in American financial assets; for example, Taiwan's 1984 large current-account surplus and increase in official reserves added to the flow. Moreover, the United States is a safe haven for capital fleeing new uncertainities and risks, as in the Philippines and Hong Kong since the early 1980s.

The increasing interdependence of the United States-Pacific basin economic relationship has not been limited to finance flows. Japanese direct investment in manufacturing, commerce, and finance in the United States is now greater than United States investment in Japan. Other Pacific basin direct investment in the United States is much more limited in amount and objective; however, Korean conglomerates, which now rank in the largest 100 non-United States industrial enterprises, have recently started production of video cassette recorders and other consumer electronics in New Jersey and Alabama. This evolving pattern of trade and investment shows up in technology licensing arrangements as well. In the past, American companies licensed their technology to Pacific basin enterprises; increasingly, such contracts have included cross-licensing provisions, to take advantage of improvements made by Japanese, Korean, or other licensees. And Japanese steel companies have signed major technology export contracts with their American counterparts.

Thus, in virtually all dimensions of United States-Pacific basin economic relations – trade, direct investment, finance, and technology transfer – the United States involvement has become both absolutely and relatively large, and an increasing share flows to the United States rather than from it. This process has provided challenges as well as opportunities and has added new dimensions to the management of what used to be overwhelmingly a merchandise trade relationship.

Current United States Policy Issues and the Pacific Basin

The United States now has such major problems in its international economic relations – especially with the Pacific basin economies – that it is approaching a crossroads in its basic principles, policies, and practices. Put simply, will the United States continue its commitment to and leadership of an open, multilateral, international trading system based on the General Agreement on Tariffs and Trade (GATT), or will it become protectionist? These are systemic issues of deep importance not only to the United States and the Pacific basin economies but to all participants in the interdependent world economy. Within this context the Pacific basin relationship is of special importance. Because it is the largest and most dynamic of the United States regional trading relationships, American interests are significant. And the Pacific basin relationship, particularly with Japan, has been a major catalyst in provoking the current United States trade policy debate.

The most direct and fundamental international and Pacific basin problems that the American economy faces are twofold. The first is the huge trade and current-account deficit. The second is the need for structural adjustment of those American industries, or more appropriately segments thereof, that have lost long-run competitiveness as labor costs have become too high relative to the degree of technology and capital employed. As already noted, more than half of the United States trade deficit is with the Pacific basin. And the need for structural adjustment – in steel, small-sized automobiles, clothing, footwear, and others – is, to a significant degree, a consequence of imports from very price-competitive Pacific basin producers. Moreover, the excessive trade deficit and overvalued dollar have exacerbated the difficulties of structurally declining industries and have hurt virtually all American manufacturers – forcing more rapid, severe, and often more extreme adjustments than a more normal balance of payments position would warrant.

These two problems, though deeply interrelated, are essentially different – in origin, time dimension, and policy solution. The United States balance-of-payments problem is short- to medium-run. The huge trade deficits cannot persist in the long run; they will be resolved either by a more successful United States macroeconomic policy mix, a major United States recession, or a decline in foreign willingness to lend indefinitely and in increasing amounts to the United States. The structural adjustment problem is essentially long-run.

For both problems there are many causes, a combination at home and abroad of current economic conditions, economic policies, and underlying cyclical and structural factors of American saving, investment, productivity performance, and lack of export orientation. The burgeoning trade deficit has been in part a consequence of specific circumstances. The debt crisis caused United States exports to Latin America to decline by one-third between 1981 and 1984, while imports rose. The unusually rapid recovery of the American economy brought about an unprecedented 26 percent increase in imports in 1984; the United States overall trade deficit almost doubled between 1983 ($58 billion) and 1984 ($108 billion). Nonetheless, the main cause of the United States balance-of-payments problem is the overvalued dollar; the main cause of the structural adjustment problem is the evolving structure of comparative (competitive) advantage around the world.

Why is the dollar so overvalued, and why has its value persisted so long? The answer is deceptively simple: the United States is spending more than it is producing, and foreigners are willing to lend the United States the funds to finance the difference, which is reflected in real terms by more American imports than exports of goods and services. Rising American domestic investment and defense expenditures have outstripped Americans' willingness to save. The gap is essentially attributable to the huge and rising United States government budget deficit. Noninflationary financing of the deficit mandates high interest rates on government bonds and hence all other financial assets, which are attractive to foreign as well as American savers. In the current system of market-determined flexible exchange rates, foreign capital inflows have dominated trade flows, increasing the demand for the dollar and raising its price in terms of foreign currencies. Foreigners have been willing to lend to the United States (purchase United States financial assets) because interest rates are so much higher than at home, the United States is a safe haven, and their own governments – notably in Japan and Western Europe – until recently have been pursuing policies of fiscal restraint that have retarded domestic growth and investment opportunities.

The United States made a major policy shift with its decision, announced 22 September 1985, to engage in coordinated intervention in the foreign exchange market to push down the value of the dollar in cooperation with Japan, West Germany, the United Kingdom, and France. The initial impact was successful: the dollar quickly declined by some 12 percent as possible and actual intervention created new uncertainties in the foreign exchange markets. Whether intervention succeeds in the longer run depends on these countries' pursuing more appropriate macroeconomic policies – notably budget deficit reduction and monetary ease in the United States, and domestic demand expansion in Japan and West Germany.

The structural adjustment problem is best seen in a long-run, global context. Under the leadership of the United States, despite the difficulties of the past decade and a half, world economic growth and prosperity since World War II have been unparalleled. A multilateral, increasingly open international trade, monetary and financial system has been created and sustained. In even longer-term perspective, the world economy has been transformed by the continuing geographic spread and technological deepening of the industrial revolution – from Western Europe in the 1950s and 1960s to Japan in the 1960s and 1970s, and to the newly industrializing countries, especially the Asian-Pacific NIC-4, in the 1970s and 1980s.

This process has had major implications for the United States. First, the foreign opportunities for American businesses – in trade, direct investment, technology transfer, and finance – have expanded enormously. American competitiveness (comparative advantage) and foreign demand for American products have increased dramatically in high technology manufactures and in agriculture. Second, the spread of industrial activity to new countries with low labor costs and expanding capabilities to absorb and use the most modern production technology has sharply reduced American manufacturing competitiveness in labor-intensive products and has even eroded the strength in medium-technology assembled products. Rising import competition in these now less-competitive industries has created serious problems of structural adjustment: how to rationalize production so as to be competitive, at least for particular product segments; and how to shift labor, management, and capital out of such declining industries; and how to distribute these costs of adjustment among the factors of production, consumers, and taxpayers.

The problems of structural adjustment are by no means uniquely American. They are common to all advanced industrial countries, though the sectors may differ: agriculture and labor- or energy-intensive manufacturing in Japan and in Western Europe. Imports are nonetheless only one of several forces impelling structural adjustment. Technological innovation creates new products and production processes at the expense of old ones. Consumer demand shifts with increases in income, changes in preferences, and changes in relative prices; for example, Japanese cars did not deeply penetrate the American market until the sharp rise in gasoline prices in 1979 brought about a major shift in American consumer demand to small cars, which American manufacturers did not produce in any quantity.

Third, the very success of American foreign economic policy in encouraging world growth and development has meant that the American share of world GNP (measured by foreign exchange rates) has declined from one-half to one-quarter; world growth has been faster than United States growth. Accordingly, American economic policymakers can no longer ignore the effects on the United States economy, either of changes in the rest of the world or of feedback repercussions from the impact of American domestic economic policies on foreign economies. Moreover, the decline in relative economic power has somewhat reduced the ability of the United States to lead world economic policy making and at the same time increased the priority of economic goals in overall United States foreign policy objectives. By and large, those objectives have been outward-looking and free market: to increase American access to foreign markets for exports, direct investment, finance, and other services rather than to restrict foreign access to the American market.

Practice has never lived up fully to statement of principle in any democratic society – in trade policy as in other areas – because of the propensity to base policy on compromise among competing interest groups. On trade issues, consumers, export producers, and users of imports battle with import-competing industries, their companies, and their unions. In reality, if not in perception, trade disputes essentially involve conflicts, not simply between nations but especially between interest groups within nations. In recent years, domestic political pressures have forced practice to deviate increasingly from principle; major industries have been increasingly able to obtain import protection benefits of one kind or another even though both the Carter and the Reagan administrations enunciated free trade principles. The major industries have included textiles, color televisions, automobiles, and steel. In all these cases, and indeed in virtually all instances of import restriction, Pacific basin producers have been either the major or at least a major source of supply.

The United States overall trade and current-account deficit is primarily an American macroeconomic problem and requires an American macroeconomic policy solution. Trade policy, either to restrict imports or to obtain better access to Pacific basin and other foreign markets, can change the sectoral composition and perhaps the level of both imports and exports but, since exchange rates will adjust to reflect the underlying gap between United States aggregate saving and investment, it would do little to reduce the overall trade deficit. That is, as noted above, the excess of American domestic spending over production is filled by an excess inflow of imports over exports. This occurs because of high American interest rates, foreign willingness to hold dollar-denominated financial and other assets, capital inflows, and an overvalued dollar.

The key is to reduce the exchange rate value of the dollar in order to make exports less expensive and imports less competitive. That requires a reduction of the government budget deficit in order to decrease domestic spending, reduce interest rates, and make foreign capital inflow less attractive; some monetary expansion, appropriate to offset the fiscal reduction, would also work to lower interest rates. Even so, United States import demand would no longer be the major locomotive for world growth as it was in 1984. Japan and Western European nations should at the same time reverse policies of fiscal restraint and provide fiscal stimulus to their economies, for global, American, and especially their own domestic reasons. Macroeconomic adjustment, therefore, involves not only the United States but all the major industrial economies. In mid-October 1985 the Japanese government announced domestic-demand stimulating measures sufficient to raise the GNP growth rate by about 1.25 percent. Nonetheless, the near-term prospects for economic growth in the industrial nations, the Pacific basin, and the world remain quite uncertain.

The best long-run strategy for solving structural adjustment problems in troubled American industries lies in the creation of new job opportunities in the economy through steady, sustained, moderately rapid economic growth, and innovative programs for labor retraining and redeployment. Yet, it is politically tempting to help affected industries by import restrictions, particularly to ease short-run costs of adjustment. Protection, in the long run, does not create new jobs; it merely protects workers in existing jobs. Workers are diverted from more dynamic sectors to less efficient, less productive ones. The costs of protection are not only the higher prices that American consumers have to pay but the slowing down or halting of the process of adjustment itself; inefficiency continues. From the perspective of the Pacific basin, United States import restrictions cost their economies both in reduced specialization in sectors of their greatest efficiency and in slower growth.

Increased American access to Pacific basin markets is not a panacea. It will not solve the American trade balance or overall unemployment problem, but it does have significant benefits. Success enables the United States to use its resources efficiently in more productive, export-oriented industries. It deflects political pressure from the perceived alternative: the restriction of imports from the Pacific basin. Moreover, it reduces the stigma of "unfairness" applied to foreign behavior, which has become a politically important symbol in the current debate despite its limited economic substance. Most important, market opening is supportive of, indeed essential for, the maintenance of the GATT-based international economic order.

Two realities illuminate the issue of American access to Pacific basin markets. First, those markets have been opening over the past decade at probably higher rates than those of economies at comparable levels of development in other regions of the world – the rising share of United States exports going to Pacific basin economies suggests this is the case. Second, however, Pacific basin trade liberalization was typically from high initial levels of protection, and – most important – many significant import barriers persist. The United States's present economic difficulties provide opportunities for American negotiators to press Japan and other Pacific basin economies now doing relatively well to open their markets further. Nonetheless, the problem is whether the negotiators, and Congress, can extract Pacific basin concessions by threats of retaliation without actually retaliating, since United States import protection would be so costly to Americans, counterproductive, and, if large and general (such as an import surcharge), likely to invite retaliation.

Future Prospects

It is easy, and correct, to say that the medium- to long-term future prospects are indeed good for an expanding, deepening, and mutually beneficial economic relationship between the United States and the Pacific basin economies. Fundamentally, this will be a consequence of probable superior economic performance and policies of most of the Pacific basin economies. Much, however, will depend on how the United States resolves its current economic problems, since much of the stimulus to Pacific basin growth is the American market.

On average, the Pacific basin economies will continue to develop and grow more rapidly than any other world region. Japan, with its high savings rate and level of technology commercialization, will grow at a rate of 2 to 3 percentage points faster than the United States and Western Europe; its share in world GNP and world trade will continue to increase. Australia and New Zealand will do no worse than they have in the past decade, and may do better. In aggregate the Asian-Pacific developing-market economies are likely to grow relatively rapidly – the development process is well under way throughout the region.

Over time the Pacific basin economies will continue their trend toward greater openness in trade. This will be the consequence of two sorts of policies: continued reduction of import barriers, which will provide outsiders greater market access, and more export-oriented rather than import-substituting policies in the resource-rich Southeast Asian economies and possibly Australia and New Zealand. In Japan, despite many actions to open the economy, significant import barriers remain in specific sectors and products in which either the United States or the Asian-Pacific developing economies are very competitive. With persistent outside pressure to open markets, the passage of time, rising domestic labor costs, and a generation of farmers approaching retirement, Japan's imports will probably rise over time as a share of its GNP. Taiwan and South Korea, despite very high import/GNP ratios, still maintain many import barriers; as they continue to grow, these barriers will be reduced.

One great unknown in the future of the Pacific basin is China. Its potential as a trading partner is huge, though the present level is still relatively modest. Nonetheless, China's involvement in the world economy has increased dramatically over the past five years as a consequence of major domestic policy changes and exceptional economic performance. American interests involve technology transfer, coproduction, and direct investment as well as ordinary arm's length trade transactions. If China persists on its present policy course and is successful, it will become a significant economic player in the region.

These are optimistic projections. They rest on an assumption that the Pacific basin economies will continue to perform better than the world economy. Should the world economy perform poorly, then the Pacific basin economies will not do well in absolute terms. The dramatic slowdown in growth performance by a number of Asian-Pacific developing economies in the first half of 1985 invites caution. Is it essentially a cyclical phenomenon keyed to the slowed performance of the United States economy since mid-1984, or does it reflect more serious domestic structural difficulties in a number of cases?

Individual Asian-Pacific developing economies may develop severe problems—probably emanating in the political arena but spilling over into economic policy. But the Pacific basin should not be overestimated or underestimated as either the savior or the *bete noir* of the United States's international economic position. Three-quarters of American merchandise exports still go to other parts of the world, and that ratio will remain high. The United States economic involvement with Western Europe will continue to be major. Western Europe will continue to be one of the three pillars, together with the United States and Japan, of the international trading, monetary, and financial systems.

American trade negotiators have on their agenda a host of specific issues with individual Pacific basin economies. These include a large number of market-access problems for specific American products and services; provision of adequate protection for United States patents, copyrights, and other intellectual property rights; stamping out of counterfeit production of brand name items; and market access for United States direct investment. How these negotiations proceed, and indeed how the Pacific basin economies perform, will be significantly affected by the ways in which the United States resolves its overall trade deficit and structural adjustment in major industries. The United States is, after all, the world's largest economy and the most important force in international economic policy.

The mechanisms by which the United States trade deficit is reduced will be significant, since they will provide support either to those forces emphasizing market access or those urging protectionism. Scenarios range from optimistic to pessimistic.[8] Two assumptions are crucial. How well will American policymakers handle the budget deficit? To what degree will Japan and Western Europe pursue expansionary domestic demand policies to increase their own growth rates and to take up the slack in world trade demand generated by a reduction in the United States trade and current account balances? Clearly, it is in everyone's interest that the United States solve its balance-of-payments problem through export growth rather than import reduction through protection or recession.

The future seems more uncertain than usual. Certainly, policymakers in Japan and elsewhere in the Pacific basin have much to do to resolve ongoing problems in their relationship with the United States. American policymakers have even more to do. One thing is certain: the Pacific basin economies will not go away. They will continue to provide both opportunities and challenges to the United States. The Pacific basin economies are not the ultimate cause of the United States's overall trade problems, though they are its leading symptom. How the United States deals with these basic realities, in both its regional and its global policies, will fundamentally affect the future United States-Pacific basin economic relationship. And how the United States resolves its current trade difficulties with its Pacific basin trading partners is likely to be the major test of its present commitment to an open, multilateral, global economic system.

Notes

1. Most of the statistics in this essay are derived from various issues of standard sources, including the U.S. Department of Commerce, *Highlights of U.S. Export and Import Trade* (FT 990) and *Survey of Current Business*; and World Bank, *World Development Report 1985* (New York: Oxford University Press, July 1985).

2. Hugh Patrick, "The Asian Developing Market Economies: How They Have Affected and Been Affected by the United States-Japan Economic Relationship," *Proceedings of the Columbia University Conference on Interdependence in the Pacific Basic*, ed. Ronald Findlay (forthcoming).

3. Hal Hill and Brian Johns, *The Role of Direct Foreign Investment in Developing East Asian Countries* (*Weltwirtschaftliches Archiv*, forthcoming).

4. "International Bank Lending Trends," *World Financial Markets*, Morgan Guaranty Trust Company, July 1985, p. 5.

5. See, for example, International Monetary Fund, *World Economic Outlook – April 1985* (Washington: IMF, 1985); and "Crossroads Europe," *World Financial Markets*, June 1985.

Mr. BEHR. Thanks, Professor Patrick.

We have heard that the core of the problem may lie in the mismatch of macroeconomic policies on the part of the United States and Japan. Of course, these policies are the product of political policies in both countries.

We have seen that the development of this trade problem as one of the Nation's foremost issues has caused a rethinking of the political wisdom in this country. One of the first pieces of legislation next year is expected to concern trade and this panel is evidence that Members of Congress are looking for something other than the old alternatives of free trade and protectionism.

At the same time, we see evidence that Japan has begun a basic political debate about its future role in the world economy, and our next panelist can help us understand that debate in greater detail.

He is Nathaniel Thayer, School of Advanced International Studies at Johns Hopkins University.

STATEMENT OF NATHANIEL B. THAYER, DIRECTOR OF ASIAN STUDIES, SCHOOL OF ADVANCED INTERNATIONAL STUDIES, JOHNS HOPKINS UNIVERSITY

Mr. THAYER. Thank you. I don't know how or when the panelists' papers were delivered to you. I do know my paper was not among them. Like my Japanese counterparts, I don't deliver my product until it's absolutely needed. I have a prepared statement and copies are available at the desk outside the caucus room.

What I would like to talk about today is Japanese decisionmaking. I want to talk specifically about Japanese decisionmaking relating to the other countries of East Asia and the United States. I want to talk about Japanese decisionmaking in its international context.

My thesis will be that I am not at all sure that the Japanese leaders are going to be able to face up to the international challenges that are confronting them.

Specifically, I would like to talk about three developments in Japan. One is the emergence in Japan of a very strong grassroots movement which is driven by a popular desire to have the Government play a greater, more active role on the international scene.

The second development that I want to talk about is the centralization of the making of Government policy into one of the organs of the majority party, the Liberal Democratic Party.

And the third development that I want to talk about is the breakdown—maybe breakdown is too strong a word—we'll search for another one—the breakdown in the grooming of national leaders.

Let me start then first with the popular movement to become more international. Open a Japanese history textbook, turn to the index and look up the word "grassroots." You won't find very many entries: a few peasant rebellions, a couple of religious crusades, that's about all.

Social movements in Japan usually start at the top and trickle down. That historical fact makes this current movement in Japan quite exceptional. It started at the grassroots and it's percolating up. Its basic tenet is that Japan must do more in international society.

The movement itself has been going for about a decade now, perhaps a decade and a half. I went through my notebooks last night to pick out statements that Japanese have made to me or that I have read in articles discussing this internationalization movement. Let me offer several of them to you here to give a flavor of what the movement is all about. I quote:

> Japan is a homogenous society. That makes internal communication easier than external communication. Hence, Japanese look inward. Japan must fight to reverse this tendency.

Another quote:

> Japan must stop acting like a minor power.

A third quote:

> Japan's contributions to the world scene should be cultural and economic, not political and certainly not military.

A fourth quote:

> Japan should not strike out on its own, but should work with other states to establish a global management system. The United States should head the effort.

A fifth quote:

> Japan has particular responsibilities toward East Asia. East Asia is its backyard. It has proposed a whole series of steps that should be taken in East Asia.

I won't read the various quotes that I have gathered that explain Japanese policy toward Southeast Asia. Let me just say that the Japanese have set forth quite an ambitious program to fulfill the needs of East Asia.

The conclusion that I want to leave with you is that almost anything you read about this international movement will be quite heartening. The question, of course, is how does this sentiment get transformed into Japanese Government policy?

JAPANESE GOVERNMENT—POLICYMAKING

Parallel with the development of this internationalization movement but going in exactly the opposite direction has been the changes in the making of policy within the Japanese Government. For many observers, Japan has been the ultimate administrative state. The best schools in the country are given over to the training of its bureaucrats and for a number of years the bureaucrats really did run the country. Now their role has considerably diminished.

What has happened? in 1955, several conservative parties merged to create a new single conservative party, the Liberal Democratic Party. It became, and has remained, the majority party.

The first real—and last—challenge to the LDP came in 1958. That election was the last election which an opposition party ran enough candidates to take over the Government. They were unable to do so. Since that time, the LDP has felt confident that it would form the government even were it to lose an absolute majority.

In the election held in the summer of 1986, the Liberal Democratic Party got more seats than it has ever had before. So the LDP is, as the Japanese call it, a party for half an eternity. It's been in power 30 years. There is nothing to suggest that it won't be in power well into the future. That the LDP has been and will be the majority party has given its politicians great strength.

Why has the LDP consistently won these 12 elections over the past 30 years? They have stayed with a single campaign theme: "We run a better government than anybody else." The populace has accepted that statement and has voted them back into office.

That has meant that the politicians themselves have been greatly concerned with the running of the country.

Most policy is made not in the national assembly, the Diet, but in an organ of the Liberal Democratic Party called the PARC, Policy Affairs Research Council. Not very many Americans have yet paid much attention to it, but they are advised to do so. Rather than the Prime Minister and his Cabinet, rather than bureaucracy, it makes new policy and reviews old policy.

Let me describe some of the PARC characteristics. It is composed of many committees—over a hundred if you count the subcommittees. Every LDP Diet member belongs to at least one of the committees. Generally, he belongs to several.

Needless to say, with a hundred committees, the jurisdictions of the committees overlap and that's the cause of much infighting. Meetings of the important committees are held regularly, usually early in the morning—if you're going to be a successfull Japanese politician, you must start your day early—meetings of the committees are not open and testimony is not recorded.

Membership on the important committees is huge—over a 100 members on the three largest. That makes it hard how the committee has reached a decision. There are rings within rings of politicians. How does one make the inner-most ring? Seniority counts and so does ability. Generally, the chairman of the committee is the most junior member of the inner-most ring of decisionmakers. Who the other decisionmakers are requires a little bit of study.

It's safe, though, to say the committee is meeting place for the bureaucrats, for the politicians, and for the special interest representatives. Each group has the power to check the activities of the other group. If the three groups aren't in accord, nothing happens. If they are in accord, then only another committee can check the action of the first committee.

The committees may or may not work well in fashioning domestic policy. You have to decide that case by case. The committees often don't do well in deciding international matters. The politicians aren't willing to serve on the international committees. They cannot serve unless they have a very, very safe electoral district. It's a luxury to serve on one of the international committees. Service on an international committee brings no votes at election time.

However, a politician who chairs a regional development committee, a politician who is director on the roads committee, inevitably gets reelected.

In economic matters particularly, U.S. negotiators have many times been frustrated by these committees. That has happened, even though the Japanese bureaucrats point out to the Japanese politicians that the U.S. case has merit and the politicians agree, but not to the extent of sacrificing domestic interests.

One of the reasons for the United States failure in Japan has been that the United States companies have not yet acquired the expertise to be able to lobby successfully in Tokyo. The first rule for lobbying, incidentally, in Japan is that lawyers don't lobby. Company presidents do.

The only individual who can successfully challenge the PARC committees is the Prime Minister, but a Japanese Prime Minister is not strong. In Japan's first Constitution the Prime Minister isn't even mentioned. Ministers reported personally and directly to the Emperor. In Janpan's present Constitution, the Prime Minister's powers are specified. He runs the Government through a Cabinet whose officers he appoints and discharges. But matters don't even come to the Cabinet until they have gone through the PARC committees and generally the Prime Minister must bless what the PARC committees given him.

Since 1885, the year that Japan's first Cabinet was made, Japan has had 44 Prime Ministers. On the average, a Prime Minister's tenure in office is a little over 2 years. With that short stay, there isn't very much a Prime Minister can accomplish. Certainly he has no time for institution building.

The LDP is divided into factions. The leaders of these factions form aliances and negotiate among themselves over who among them shall be the next Prime Minister. A Prime Minister will be good at the care and feeding of other politicans. That's how he nurtures his faction. A faction leader need not be popular. His electorate is, for the most part, the four or five other faction leaders.

Building a faction takes many years and from one perspective that's good. That means that every prime ministerial candidate will have had to demonstrate his political abilities in the factional wars before he gets into office. From another perspective, faction building takes so long that nobody gets into office until he's in his sixties.

Nothing I have said so far suggests that a prime ministerial candidate must have a competence in foreign affairs. Consider this: The LDP has put into office 12 Prime Ministers. Six of these Prime Ministers have had to leave office for alleged failures in foreign policy and three of the six have had to leave office for alleged failure in handling the American relationship.

How then do most Prime Ministers approach foreign policy? With extreme caution.

It's against this background that I ask you to consider Nakesone's tenure in office and the tenure of future Prime Ministers.

I pause here to advise you that I've known Nakesone for 25 years. I'm writing a biography of him. But it is not a hagiography. I like him. I think I'll say that in the book. I think he's done well. I'll say that in the book, too. But I intend to be critical as well.

When Nakesone assumed office he was regarded as a weak Prime Minister. His factional alliances were in disarray. He was seen as the shadow of another man. Few thought he would stay in office even for 2 years.

He has surprised his critics. This November he started on his fifth year in office. He still has more time to go. How did he do it? Luck was on his side. Polls show that commodity prices are the thing that determine the popularity of the Cabinet. Commodity prices during Nakesone's 5 years haven't risen very much.

Nakesone has also shown skill in getting his legislative programs through the Japanese Diet. But most importantly and unlike any other Prime Minister, Nakesone has taken initiatives in foreign policy. He's seen it not as a problem but as a challenge. He's not been cautious. He's stepped out. He's spoken out on issues. He's commanded attention overseas, something which no other Japanese Prime Minister has ever done.

For taking these unusual actions, he's received tremendous popular support. The six Prime Ministers who came before Nakesone generally averaged popularity ratings maybe as high as 40 percent at times but generally lower, sometimes below 20 percent. Nakesone has been able to lift and hold the fortunes of his party, of his Cabinet, and of himself up over 50 percent.

The ability to command popular support at home and the attention abroad has given him the power at least in foreign affairs to get the PARC committees to respond to his requests. That, in turn, has boosted his stock overseas. That, in turn, has helped him at home. Nakesone has been traveling in very good circles.

Nakesone's success should not obscure the fact that sooner or later he must step down from office. Sooner may be next June. Later may be November 1987. There's one scenario that leaves him in office until November 1988. Nothing precludes him from coming back to office after he's stepped down.

When Nakesone goes, who replaces him? Well, there are three faction leaders waiting in the wings. Two of them have had experience in foreign affairs as foreign minister. A third has been finance minister and has gotten foreign exposure that way. All should be able to solve foreign problems. But polls do not show them to be popular at home and they don't cut a very broad swathe overseas. They need to get attention if they're going to be able to persuade the PARC committees to give a Prime Minister what he wants and it doesn't look like they are going to be able to do that.

I find it easier to view these three new leaders not as men who will step forward from where Nakesone has stood, but rather to go back and follow the footsteps of earlier Prime Ministers. I see each of these Prime Ministers taking his turn in office. I don't see the event that will cause the party to give them more than their usual 2 years in office. After these three are gone, all is darkness.

The LDP has lots and lots very attractive politicians who would make excellent Prime Ministers, but they are buried deep in the factions. I don't see how they get to the top of their faction much less into the Prime Minister's office.

What then happens to the people's desire to play a greater international role? I see it as being honored in part. The LDP always has a little something for everybody. But I don't see the PARC committees changing very much. They will maintain their domestic orientation. The United States will suffer a little bit from that. Thank you.

[The complete statement of Mr. Thayer follows:]

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A new international order is emerging in East Asia. Guiding it are some economic laws.

> A clever government can induce economic growth. No need to sit around and wait for textbook forces to work.
>
> Economic growth brings stability. Stability brings economic growth.
>
> The legitimacy of a government depends on its ability to induce growth. The formula seems to be the higher the growth rate the more tolerable the government -- to a point.
>
> Economic growth is best secured through international cooperation. Old hat and long gone are desires for autarky.
>
> Not an economic law but a political reality is that most developing nations are watching what is happening to the East Asian nations to see if those nations' experiences constitute a model for them. After watching the small Chinese city states succeed, China has decided to experiment with a mixed economy. Other nations may follow.

Japan and the United States are integral to the growth in East Asia. The United States furnishes international security. Japan purchases raw materials. Both nations provide technology, investment, and markets. And both nations have industries who believe that they are getting the dirty end of the stick since most East Asian nations have opted for a government-stimulated, export-oriented development strategy. Both nations will test over the next few years whether the formulas they have come up with are adequate to keeping domestic industries stroked and East Asian industries growing.

I leave to others to describe what is going to happen in the United States. I see my role today to describe what is going on in Japan. My thesis is that Japanese leaders may not be up to the international challenge confronting them.

I would like to talk about three developments in Japan. The first is the emergence of a strong grass roots movement in Japan to have its government play an more active role on the international scene. The second development is the centralization of the making of government policy into policy organ of the Liberal Democratic Party (LDP), the majority party. The third development is the breakdown in the grooming of national leaders.

THE MOVEMENT TO BECOME INTERNATIONAL

Open to the index of your Japanese history book. Look up grass roots. Except for some short-lived peasant rebellions and some religious crusades, there are no entries. Seminal social movements start with the elite and trickle down.

The current movement in Japan is quite exceptional. I am not sure where it started. But the newspapers have reported it on their news pages and supported in their editorial columns. Now it percolates up into government. Its basic tenet: Japan must become part of international society.

The movement is remarkably durable, having gone on for over a decade. I have culled from my notebooks some of the statements that Japanese have made to me or I have read in articles discussing Japan's internationalization. Let me offer them here. They give a flavor of what the movement is all about:

> Japan is a homogeneous society. That makes internal communication easier than external communication. Hence Japanese look inward. Japan must fight to reverse this tendency.
>
> Japan must stop acting like a minor power.
>
> Japan's contributions to the world scene should be cultural and economic, not political, certainly not military.
>
> Japan should not strike out on its own but should work with other states to establish a global management system. The United States should head the effort.

Japan has long felt a special responsibility toward East Asia. Those responsibilities get enunciated in the talk about internationalization. Through the autumn 1985 into the spring 1986, the Ministry of International Trade and Industry (MITI) underwrote eight discussions of Japanese scholars and other distinguished citizens. Let me offer some of their thoughts about East Asia:

> Since the American market is sluggish, Japan must provide a larger market for East Asian products so that East Asian nations can continue to grow.
>
> In the past, East Asian culture entered Japan through the West. Now cultural exchange should be direct.
>
> Through its relations with the Asian NICs, Japan can establish a new model of cooperation for North and

> South nations.
>
> Japan can contribute to pan - Pacific cooperation by establishing information infrastructures. Maybe energy development would be a good subject for such cooperation, too.[1]

Towards the end of World War II, Secretary of the Treasury Henry Morganthau argued that Japan should be turned into a pastoral state and never allowed to have an international presence again. He was opposed by Under Secretary of State Joseph Grew and Secretary of War Henry Stimson. They argued that Japan should be helped. Its values were close to United States' values. In time, it would come to help build a world at peace. Almost everything one hears and reads about the internationalization movement buttresses the Grew-Stimson view.

THE MAKING OF POLICY

Parallel with the development of the internationalization movement, but going in the opposite direction, have been changes in the making of policy for the Japanese government.

For many observers, Japan has been the ultimate administrative state. Young samurai, trained in the administration of the feudal estates, constituted the core of the forces which overthrew the Shogun and set Japan on the road to becoming a modern state. Most of the prewar ministers and more than half of the postwar prime ministers came from a bureaucratic background. The best schools in the nation are schools that were created to train government officials and still fulfill that function. History, the chance for high office, a desire to be recognized as one of the best and the brightest encourage talented Japanese youth to enter government service. And for a number of years, the bureaucrats really did run the country. Now their role is diminished.

Two political parties, the Liberal Party and the Democratic Party came together to form the Liberal Democratic Party, which became the majority party in 1955. The last election in which the strongest opposition party ran enough candidates to take over the government was held in 1958. The LDP won more seats that it had ever had before in 1986. For thirty years, then, the LDP politicians have ruled the nation and there is every indication that they will continue to do so. The Japanese call the LDP,

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[1] Yasusuke Murakami and Yutaka Kosai, ed., Japan In The Global Community, (Tokyo: University of Tokyo Press, 1986) pp 39-42.

"the party for half an eternity."

The LDP politicians went to the country at each election with the same message. We can run the country better than anyone else. The electorate accepted that claim and returned them to office. Always on the front burner for the LDP, then, was consideration of government policy.

The situs for the consideration of policy in the LDP has been the Policy Affairs Research Council (PARC). More than the ministries, the Diet, the cabinet, it makes policy. What are its characteristics?

> It is composed of many committees -- well over a hundred if the subcommittees are counted, too. Every LDP Dietmen belongs to at least one of the committees. Generally, he belongs to several.
>
> Needless to say, the jurisdictions of the committees overlap and that is the cause for much infighting.
>
> Meetings of the committees are not open and not reported.
>
> Membership on the important committees is huge, which makes it hard to tell how the committees reach decisions. Seniority does count. So does ability. Generally, the chairman is the most junior of the inner ring of decision makers.
>
> It's safe, though, to see a committee as the forum for the bureaucrats, the politicians, and the special interest representatives. Each group has the power to check the action of the other groups. If the groups are not in accord there is no action. If there is accord, only another committee can check its action.

The committees may or may not work well in the fashioning of domestic policy. One must judge case-by-case. The committees often don't do well on international matters. Politicians who chair a regional development committee or are a director on the roads committee never lose an election. Politicians refuse to serve on a foreign relations committee unless they have strong districts.

In economic matters particularly, United States' negotiators have many times been frustrated by these committees. That has happened though the bureaucrats point out the United States' case has merit and the politicians agree. One reason for the failure is that the United States' companies have not yet acquired the expertise to lobby successfully. The first rule for lobbying is, incidentally, that lawyers don't lobby. Generally, company presidents do.

If the United States has difficulty getting their interests recognized, imagine what will be the fate of a small Asian country.

THE POWERS OF THE PRIME MINISTER

The only individual who can successfully challenge the PARC is the prime minister who is also president of the LDP. But his office is not strong.

Japan's first constitution, the Meiji constitution, did not mention the prime minister. Ministers reported directly to the Emperor. Japan's present constitution, the Showa constitution, assigns the prime ministers specific powers to run the government through a cabinet whose officers he appoints and discharges. But matters don't come to the cabinet before they are thoroughly worked over in the PARC. Generally, then, the prime minister ends up blessing what the PARC gives him.

Since 1885, a little more than a century ago, Japan has had 44 prime ministers. On average, a prime minister's time in office is a little over two years. That short stay in office limits what a prime minister can accomplish. Maybe his name will be hooked to a major piece of legislation or an important treaty and he will come to be remembered for its passage. A prime minister does not have any time for institution-building.

The LDP is divided into factions. The leaders of these factions form alliances and negotiate among themselves to settle whom among them will be the next prime minister. A faction leader will be good at the care and feeding of other politicians since he needs that talent to nurture a faction. A faction leader need not be popular, since his electorate for the prime minister's post may be only four or so other faction leaders.

Building a faction takes years, many years. From one perspective, that's good. The prime ministerial candidate will have had to demonstrate his abilities in the factional wars before he achieves office. From another perspective, faction-building takes so long that only a few men have gotten into the prime minister's chair before they reached sixty years of age.

Nothing I have said so far suggests that a prime ministerial candidate must have demonstrated a competence in foreign relations. Consider this: The LDP has put into office twelve prime ministers. Six of those prime ministers have had to leave office for alleged failures in foreign policy. Three of those six prime ministers have had to leave office for alleged failure in handling the American relationship. How then do most prime ministers approach a foreign policy issue? With extreme caution.

It is against this background that I ask you to consider Nakasone's tenure in office and the tenure of future prime ministers.

I pause here to advise that I have known Nakasone for 25 years and I am in the midst of writing a political biography of him. I like him. I think he has done well. I will say so in my book. But it will not be a hagiography.

Nakasone assumed the prime ministership regarded as a weak prime minister. Few thought he would last even two years. He has surprised his critics. He has lasted five. And he still has more time to go.

How did he do it? Luck was on his side. Polls show that commodity price rises is the most important element that turns a voter against a prime minister. During Nakasone 's tenure prices have not risen much. Secondly, Nakasone has shown skill in getting his legislative program through the Diet.

But most importantly, and unlike any other prime minister, Nakasone has taken the initiative in foreign policy. He has seen it not as a problem but as a challenge. He has not been cautious . He has been bold. He has spoken out on issues and has commanded attention overseas, which no other prime minister has done. For taking these unusual actions, he has received tremendous popular support. The six prime ministers who came before Nakasone had support percentages that rose at least on one occasion to 40% but generally hovered around 30%. Nakasone has raised the support rate for his cabinet and for the LDP to over 50% and sustained it. And he turned these popularity percentages into votes if the 1986 elections are evidence.

The ability to command popular support at home and attention abroad has given him power, at least in foreign affairs, to get the PARC committees to respond to his requests. That response has further boosted his stock overseas. Nakasone has been travelling in good circles.

Nakasone's successes should not obscure the fact that sooner or later, Nakasone must step down from office. Sooner may be as soon as June 1987. Later may be November 1987. One strategy leaves him in office until November 1988. Nothing precludes him from coming back to office after he has once stepped down, but only one prime minister has been able to do that since World War II.

When Nakasone goes, who replaces him?

Three faction leaders wait in the wings. Two have had experience as foreign minister. The third has had foreign exposure as finance minister. All should be able to solve foreign problems. But polls show them not to be too popular at home. And they have not cut a broad swath overseas. They will need a cachet if they hope to persuade the PARC committees to give up their domestic orientation.

I find it easier to view these faction leaders not as men who will stride forth from where Nakasone left off but rather search out and follow in the footsteps of earlier prime ministers. I can see each of these three men taking his turn in office. I do not see the event that will cause the party to give them more than the usual two years in office.

After the three, all is darkness. The LDP has many attractive young politicians who would make excellent prime ministers. In times past, these young men would have fought to create or take over a faction and would have become better politicians for the experience. Nowadays, that seems foolhardy since the factions are too big, too entrenched to be assaulted by one man. I don't know how future prime ministers will come to power. And not knowing that makes it hard to judge what sort of men future prime ministers will be.

Japan is a democracy. Elections are fierce. And people do change their vote, some from party to party, some from candidate to candidate within the same party. I do see a new pattern emerging from the 1986 elections. Maybe as many as fifty men were able to win a seat in the lower house through the prime minister's popularity. They will be looking for a popular prime minister to help them maintain that seat when elections come three years from now. These men may not be willing to accept the judgement of faction leaders as they choose one of their number to sit in the prime minister's chair.

What happens to the people's desire to have their nation play a greater international role? It will be honored in part. The LDP always has a little something for everybody. But I don't see the PARC committees changing much. They will maintain their domestic orientation. The United States will suffer a little from that. The East Asian countries will suffer more.

Mr. **Behr**. Thank you.

Summing up a bit, we heard at the outset from Professor McCraw that a major part of Japan's competitive advantage is based on a set of deep-seated cultural and institutional structures that are aimed at making Japan a very strong trading nation. And Professor Thayer has told us that the political system that supports these institutions will be very difficult to change.

We now turn to the question of how much of the American competitive problem is based on our cultural and institutional arrangements and whether those should be changed.

And we will be hearing from Professor Ronald Morse, who is the secretary of the Asia program at the Woodrow Wilson International Center for Scholars. Mr. Morse.

STATEMENT OF RONALD A. MORSE, SECRETARY, ASIA PROGRAM, WOODROW WILSON INTERNATIONAL CENTER FOR SCHOLARS, WASHINGTON, DC

Mr. **Morse**. Thank you. What I'd like to do is start off by projecting what I think are the trend lines in what we can expect from Japan, looking toward the 21st century and then focus on what I see as the institutional dimension. Hugh Patrick has talked about the macroeconomic factors. Many people are familiar with the microlevel negotiations that go on at several levels. I think one of the overlooked factors in the United States-Japanese relationship is the much more fundamental levels, the institutional and structured ways that we go about being competitive.

I have titled my paper "United States-Japan Economic Olympics" because I think we're engaged in a form of competition which is regulated in a way that competitive sports are; namely, to minimize injury as much as possible although we know some injury takes place. The quarterback gets sacked. The players' legs get broken—injuries occur. But it differs from war in the sense that in war the intention is physical damage.

I think we're engaged in a very moderated form of sports competition with Japan and one within which the rules of the game are such that there's nothing unique about what Japan has accomplished. There's very little that the United States cannot do to accomplish the same type of objectives. In fact, America is probably in a better position to accomplish these same objectives.

I want to phrase my comments in terms of sports competition to draw out some of these structural comparisons.

The first thing is that those of you who have read "Megatrends" and read other books about where societies are headed in the future will recognize that there's very little that one would not find in Japan that is not found in the future of the United States and the future of other industrialized countries. They are going to be information societies. They are going to have aging population structures. These societies are also going to be more pluralistic. In this sense I would differ with Nat Thayer in that I think we're going to see "new" politics in Japan just like we've seen new politics in this country and other countries. The Japanese have always been very good at producing statesmen and leaders and I don't think that they will have any shortage of good people in the future.

In the 25 years ahead, there's going to be more basic research in Japan as opposed to applied research. They are going to have an active space program. There's nothing to say that they won't become a nuclear power in the 1990's and they are going to have a service-industry oriented society much as we have today. In fact they are already about at the same level we are.

If you go back in history and look at how England developed into an empire, how the United States went through its transformation, and you look at what's happened in Japan, essentially they are similar. You had three societies that were essentially closed to the outside, developed strong domestic industries, gradually, opened up, and eventually became foreign investors and capital exporters.

The difference is that in the case of England they had over a hundred years to accomplish it. In the case of the United States, maybe 60 years. Japan has this compressed into a very short period which accounts to some extent to why they have been so slow in transforming their society from a very closed society to an open one.

They have already moved into the capital exports and service industries at a very rapid pace. In fact, most societies would probably crack under similar development stress if they weren't as well organized as Japan is. For that reason, Korea and Taiwan also present interesting cases where this kind of accelerated stres, the transformation of social, political, and economic institution is very important.

Now within that context, let me say that there are a couple of things that I think we have tended to mislead ourselves about. For example; we often believe that we have a goverrnment that really is out to protect American economic national interests. Very often I think it raises serious questions. In many ways we are not structured at the national level to defend our own interests.

This country was built in a period of time when adversarial relationships were very important and certain types of institutions were formed that worked very effectively. But to people who have looked at development societies this type of adversarial relationship structure doesn't work well when the well organized or late comer challenges.

Japan, Taiwan and South Korea are societies in which an adversarial relationship will not help them leapfrog into the kinds of economic and political developments they want. And we, I would argue, to compete with these late-developing nations that do not have the same adversarial structure will require structural adjustment on our part. We cannot have diverse organizations that pretend to coordinate and look our for American foreign and domestic economic interests without any type of real sophisticated coordination.

The other thing is assume there are rules of the game that everybody is playing. We know that we don't play by the same rules and the United States does not have enough bulldozers located in the Special Trade Representative's office and elsewhere to level the playing field.

Basically, we have to live with the existing unfair rules of the game. We can't wait to change the name of the game to try to be competitive.

With Japan, I think many of us have fallen down in what I would call peak peformance. It's very hard to keep an athlete tuned up psychologically to want to prepare for an event over a period of 6 or 8 months, and keep them ready so that in the final hour of competition they actually are up for it after this long period of intense grueling exercise.

What happens is people tend to get sloppy in their thinking and I think we have done that with regard to Japan. We used to talk about "beating" the Japanese at the trade game. Then for a period of time we started talking about, "Well, we can do as good as they can." Then we lapsed into, "Well, we have to learn to cooperate with them." I think we're in a very dangerous phase now where we have accommodated ourselves to a certain psychological "defeatism." All we do is look at our weaknesses and praise what they do so well without looking very seriously at their weaknesses and looking at our strengths. I think we have to make a careful assessment not only of our weaknesses but of our strengths.

In this context, let me say that even with an uneven playing field and even with certain types of problems that exist, it seems to me that the present system that we have isn't all that bad. Let me make an analogy to sports here just for a quick comparison. My prepared statement covers these issues more systematically.

One thing we did in this country when we decided we wanted to compete with the Russians and others in Olymbic sports was to form the U.S. Olympic Committee, a private organization. That Olympic Committee has basically done what other countries do through selection and Government intervention. With this we've moved a lot of our competitors from the 10th place in Olympic competition right up to 1st place. It's been done with the application of technology, time, effort, and science.

This is exactly, of course, what the Japanese are doing to their own economy and we seem to neglect. I think we can apply these same type principles to the kinds of problems we have today. The basic level is the individual in any kind of competitive type of activity and at the individual level there is no difference between Japanese and Americans or anybody else. Even though the Japanese prime minister thought there might be some difference in Americans, I think he's fundamentally wrong and there are no necessarily great comparative advantges that come from having come out of a Confucian tradition or an ethnically homogenious society.

So there's very little in Asian culture—there are certain little things, but very little in Asian culture that gives them comparative advantage over us.

The next step is basic conditioning and here we all know of the reports that have been published about the flaws in American education, the lapses in math training and language training in our universities and so on. So at this second level of training an athlete I think we can identify the first fundamental set of problems. We must have well-trained people just up through the high school level to be able to get them ready for what I would call the next phase or what usually is the next phase of competition, which is competition-specific training. In other words, take people who know how to use computers, take auto mechanics. To make people in any particular skill area that you want, this can be done if corporations invest in people and if the Government invests in people. And this is what the Asian countries have done.

The reason so many American graduate schools are fearful of all of the Korean and Japanese students that are coming into their universities and knocking our American graduate students is because these kids invested very seriously in what we call mechanical rote types of education. They get the basics to them and they train them for specific things so that then they can get into this phase of competition-specific training. They emphasize the basics.

A Japanese recently told me the difference in getting to this phase from the Japanese point of view and the American point of view. I think it's somewhat instructive because what we're talking about when we reach this level in industrial development, we talk about industrial policy. In other words, to what extent do government and business work together to accomplish certain objectives.

A Japanese from a large training company said take the triathlon as an example—you have swimming, bicycling, and then finally a race at the end. This is how the Japanese would structure a triathlon. First of all, for the swimming part of it the government would take all their business people and put them in a boat and they would ferry them to the other side and on the way they give them all the same information and give them all the basic opportunities for research and development they needed. We all know what this is. The Japanese have industrial policy to do this kind of thing.

The second phase, what they will do is take two or three people and put them on one bicycle. Somebody (a company) is bound to have powerful legs; another would be good at technique and somebody else can watch out where they're headed. They're not competing with each other and they're all moving forward.

In the final phase they all get off the bicycle and every Japanese has to run for themselves in head-on competition. This is what the Japanese always refer to as how competitive their private sector is.

The trouble is when the Americans start this game, they all dive in the water, from the start they compete against each other, they invest in R&D, they spend money on people, they do duplicative research and they all get out there and hustle. By the time they get to the bicycle phase they're beginning to wear down and when it comes to the final phase not many of them have the resources left to cross that finish line and get the gold medal.

Now the final phase in olympic training is what I mentioned earlier, fine tuning. In other words, there is very little difference between being No. 1 and being No. 3 or No. 5 and fine tuning decides the ranking. And where that takes place—and the Japanese have done this and I think other people have—is with the application of technology. If the Americans have faith in democracy, the Japanese have faith in technology. They worship technology and they see technology as the one way to leap into the future and get beyond the limitations of both individual productivity and all the other economic constraints that will operate on their society.

They've done this in the energy area as a response to the oil crisis to some extent. And they are going to do it in space and they're going to do it in all the other areas.

Let me sight one example, high technology ceramics, the things that make space shuttles possible, semiconductors and so on. The Japanese had very little expertise in this area 10 years ago; 5 years ago the Japanese government decided that they would organize the whole field. They would establish regional technical centers around the country that would have multiple high-tech centers. They would train engineers abroad. Some of the best people graduating from MIT in high technology ceramics are not Americans. They bought chairs—financed chairs at all the major American institutions. They have people who are well trained at Government facilities. They get them together. They very quickly built high technology ceramics in Japan—what they call in their society nontraditional ceramics.

But what they've done with ceramics in the example of the triathlon is they take a cement company or a company that makes fine ceramic powders. They put them together with a leading technology company and they get a declining industry and they say, "Okay, you guys, you work together to figure out how to beat the competitors in that game. And this is how the high technology ceramics competition is taking place today. It's true in biotechnology and any other area you want to look at.

Let me close with just a remark. When Sputnik went up, the United States mobilized its resources to, one, understand the Soviet Union; two, to translate their materials; and three, to organize our resources. Just a couple of years ago the U.S. Congress passed title VIII legislation which made available $5 million a year just for Soviet-East European studies because we felt we were falling behind. We need the same for Japan.

There's nothing to say that with the same type of dedication that a competitor, even if it's not in the area of strategic competition—though I would argue in the future there's nothing to say that is predictable. We've learned that in the past. There's nothing to say they will always be our friend and there's nothing to say that the Soviet Union's intentions in the Pacific Basin won't have an impact.

We have to look realistically at Japan as a foreign power, potentially nuclear power, and a country that has its own destiny to carve out for itself, the same way that we do. I think that once we get past those psychological hurdles and look at how we can compete on the relatively fair playing ground there is—but certainly it's not fair—and then adjust our policies, adjust our institutions, and make the investments we have to, there's no reason that we can't get the gold medal at the end of the race with Japan. Thank you.

[The complete statement of Mr. Morse follows:]

THE UNITED STATES-JAPAN ECONOMIC OLYMPICS

by

Ronald A. Morse
Secretary, Asia Program
Woodrow Wilson International Center for Scholars

Americans have been good sports when it comes to trade competition, but they are running out of patience with the way the game is played by their competitors. They also recognize that they don't have the number of bulldozers required to level, as some people say, the competitive economic playing field. If it is impossible to have equal opportunity on the field because of the differences in the rules by which we compete, the onlv alternative for Americans is to come up with a better game plan and a more competitive team. This is the way we have always thought about competition, but the time has come to do something about it.

As a nation, we have competed quite well in Asia. Japan and the United States are the primary trading partners of the top seven Asian nations (see Chart I in the Appendix). But in the last five years we have seen the significant erosion of American competitiveness worldwide. In the case of Asia, the U.S. market share for exports to the region has dropped dramatically and U.S. imports from there have grown almost to crisis proportions (see Chart II). The decline in American competitiveness varies from country to country; with Japan, the U.S. loss of market share has been focused rather dramatically in a few key areas. (see Chart III).

The fundamental economic issue for the United States, especially with Japan as its major global economic competitor, is to identify the reasons for the decline in U.S. competitiveness and to formulate a competitive strategy that preserves the existing trading system but ensures that American national interests are given priority. Time is of the essence because our Asian competitors will not lessen their effort to excel (see Chart IV).

Japan, because of the magnitude of our trade deficit with that country and because of their national determination to out-perform the United States in technological advancement and service industry productivity by the 21st century, deserves far more serious attention than we, as a nation, have so far given it.

This statement was prepared for a symposium on "United States-Pacific Rim Relations" sponsored by the Joint Economic Committee of the U.S. Congress, December 11-12, 1986.

In this context, I believe it is appropriate to refer to this U.S.-Japan economic competition as an "Olympic" event because it has many of the characteristics of intense athletic competition. By thinking of the relationship in these terms, we come closer to the spirit of the contest. The only measures we now have to gauge competitive economic success are trade balances, exchange rates, and indicators of market share; all imperfect measurements that are subject to any number of interpretations depending upon how one defines the terminology. We have not found these measures very useful as a guide to formulating successful economic policies.

Characteristic of the American postwar attitude, we have attempted to try to establish basic "rules of the economic game." We, with near religious conviction, state that we must play by the "free trade" rules. Of course, there is no clear idea what "free trade" means. We also seem willing to accept the handicaps of having others violate these trade rules, even at the risk of permanent damage to our national welfare. In this sense, when it comes to trade policy, we are our own worst enemy. We also seem to forget that as long as American business had a secure domestic market, it didn't have to think globally. But now the domestic market is no longer secure, and business has not prepared, the way the Japanese have, for international trade.

Economic Competition as Sport

Competitiveness in sport and business have certain common elements: the essential building blocks are basic health and well-being (the social and economic situation), conditioning (worker-corporate relations), special training (product competitiveness), and fine tuning (government-business cooperation).

The analogy to sport in the context of U.S.-Japan competition is not as far-fetched as one might think. We talk of our bilateral trade conflicts in terms of "levelling the playing field" (equal market access) and "building a better team" (more competitive national strategy). Various U.S. agencies—the Commerce Department, the Special Trade Representative and trade commissions--give penalties to foreign producers for trade subsidies, dumping, and even unsportsmanlike conduct—some public officials have suggested that Japanese culture must be changed. We know, however, that the sanctions we take, like one minute on the bench or a five-yard penalty, will not really decide the outcome of the trade competition. The U.S. trade managers (the White House) threaten American competitors with the wrath of the spectators (Congress?), but everyone knows that in the last analysis nothing much can be done. Our open political system, which invites lobbying and encourages foreign investment, makes it increasingly difficult for domestic groups to protect their interests. The Japanese, for example, to use a football phrase, have done "end-runs" on a number of trade related issues.*

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* Ronald A. Morse, "The Japan Lobby and American Foreign Policy Interests," Occasional Paper 22, Asia Program, The Wilson Center. Also see Ronald A. Morse and Edward A. Olsen, "Japan's Bureaucratic Edge," Foreign Policy (Fall 1983).

In this context, it should come as no surprise that America's two largest competitors, Canada and Japan, are the only other countries that have well-organized intercollegiate athletic programs. They have also adopted with enthusiasm at least two sports invented in the United States, baseball and football. It is also important to note that hosting the Olympic games has been a vital source of national pride for Asians. Japan hosted the Olympics in 1964, and as an observer in Japan at that time, it was clear that this was a benchmark in the recovery of Japan national self-confidence after defeat in World War II. Once Korea hosts the Olympics in 1988, that nation, too, will never be the same.

We cannot forget that Americans have also become a nation of "gamers," and understanding this may give us some clues to getting back on track in trade competition. The current U.S. boom in recreation and fitness is a $250 billion business. With 120 days of free time each year, many Americans are enjoying a quality of life unmatched elsewhere. Sport has also become the basis for much of what America's youth learn about life. Athletes, because of their public image and popularity, are becoming increasingly active in politics. We have even decided to assist athletes in their competition by forming our own Olympic training facility in Colorado. The United States, we know, has earned economic "gold medals" and Nobel prizes, in part because of the postwar initiatives of the government--the G.I. Bill, quality education and high-tech investments.

Strategies for Peak Performance

Generally speaking, we have few qualms with the Japanese, who are usually honest and fair in their dealings. We might be unhappy with Japan's level of security expenditures and their passive foreign policy involvement, but we pride ourselves on taking partial credit for their postwar successes. Now that the disparities in our trade relationship have grown, we are more alert to the evolution of the differences in how we both pursue economic advantage. The economic strategies of South Korea, Taiwan, and Singapore are even more radically different and pose even a greater threat to our "loose" style of competitiveness. To highlight these differences in the United States and Japan, let me focus on four characteristics that apply to competitiveness in both sports and business.

I. Fundamental Health. Here we focus on the individual, and I doubt seriously that the loss of economic strength has very much to do with the intelligence or readiness of American competitors to work efficiently once they are motivated and prepared for their work (despite the different view of Japanese Prime Minister Nakasone). This is perhaps best demonstrated by the fact that foreign investors, mostly Japanese, have been able to motivate and train our people to be peak performers here at home, while American companies without any sense of national interest trot off to foreign shores to invest. Many well-run American companies also have been very successful at home. At this individual level, I see few differences between the Asians and the Americans. The cultural myths about manual dexterity or differences in brain structure are unfounded. And the issue of how Asian "Confucian cultures" are more productive has not stood up to careful examination.

II. Conditioning comes next. With conditioning, we are beginning to deal with the interaction between people and institutions. We have all heard the criticisms of the levels of technical training and public education of the American people. We know for a fact that in recent years the United States has not invested in people in the way our Asian competitors have. Any number of studies have pointed out that we have not properly rewarded the educators (coaches? managers?) responsible for making our youth and workers proud and competitive. To be sure, we have creativity and innovation, but opportunities are not available to all in the way they should be. In this sense our Asian competitors have done better and we recognize their success in doing this.

III. Competition-Specific Training refers to the particular skills made available to a soundly conditioned person. The special skills needed for high-tech and service sector competition in the 21st century are quite different from what one must have for agriculture or industry, but they are not being developed in our nation fast enough to permit American companies to hold their own in domestic or foreign markets. While our foreign competitors invest heavily in training their people, usually at American universities, we slash the very programs that give our people these opportunities. Blind faith in "market forces" is fine, but we never relied upon it during the golden years of American growth, investment and productivity. Wisely our Asian neighbors have watched what we did and pay little attention to what we say. The Japanese learned their tricks from the United States and have applied them ruthlessly. They also intend to avoid our more recent mistakes.

Let me highlight the differences between current American and Japanese economic competitiveness strategies by making a comparison with the Triathlon race (swimming, bicycling, and running): On leg one of the race, the Japanese government prefers to put its swimmers all in a boat (arming them with research & development funding and market information) and ferry them to the other shore. The American competitors (companies) all swim independently to the other shore.

For the bicycling phase, two or three Japanese are encouraged to ride together (perhaps a strong competitor, one weaker athlete, and one rider with a good technique). Each American again rides separately, racing against everyone else. In the final stretch of the marathon contest, each Japanese finally competes individually but, given the accumulated advantages, is likely to do very well. This is exactly what the Japanese government and business have done in semi-conductors, machine tools, high technology ceramics, and are now applying to new competitive areas.*

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* High-Technology Ceramics in Japan, National Academy of Sciences, 1984. I participated in this research effort on Japanese high-technology ceramics.

A Japanese summed up this strategy by saying that "the Japanese identify the best athletes, turn them over to good coaches and give them every opportunity to perform. In the case of the United States, each corporation duplicates the investment of its competitors. The cost is high and the payoff is not always great. The adversarial relations that made for good competition in America in the past may not be all that appropriate to competitiveness in today's world. With Japanese government guidance (controlling and facilitating competition), the Japanese (and now Taiwan and Korea even more) have a comparative advantage that no amount of U.S. protectionism can do much about. If Americans don't compete on the same terms,they are bound to lose."

The most blatant statement of this Japanese national strategy came in the form of the recently much advertised "Maekawa Report." On April 7, 1986, after months of deliberation and meetings, the Japanese Prime Minister issued "The Report of the Advisory Group on Economic Structural Adjustment for International Harmony," identifying Japan's official long-range plans for developing a strong domestic economy and a "responsible" foreign policy. The report concluded that "the government obviously has a very important role to play in transforming Japan's social and economic structure." This report, an "industrial policy" for Japan, was hailed by the White House, which advocates a "free market," as an important move toward the opening of Japan. Once again we have looked for Japanese solutions to our problems—a popular form of American self-deception these days. But like so many other Japanese reports, this one hides the real issues, defers decisionmaking to the future and makes uninformed American policymakers think everything will be fine.

One last point regarding this process of government involvement in growth and national development. As with athletic training, this is a long-term process not dependent upon any one report, agreement or leader. The competitiveness challenge is the result of decades of change, and can only be reversed with a long-term understanding of the basic issues.

IV. Fine tuning is what makes the big difference between winners and losers. Here is where the psychological determination to win and scientific technique for performance gives a competitor an edge. In this regard the Japanese pose a major threat to U.S. business: the Japanese have a strong conviction that technological fixes will solve their problems. Their intentions and considerable successes in many areas of basic and applied research are already having an effect. They, perhaps correctly, believe that research and development will give them the economic advantage in the 21st century. There should be no doubts in our minds that they will pursue their interests with full determination.

They are also already applying these high-technology solutions to industrial and service sector problems. Trade in services is even more difficult to measure, monitor, and enforce than trade in manufactured goods, and the Japanese are likely to be even more aggressive in acquiring market share than they were in the industrial area. We are already seeing this happen in financial services. They can also be expected to employ new financial strategies (mergers, joint ventures, acquisitions), and to rely more heavily on employing American experts. Their global trading networks and trust in communication technology are part of this strategy. If past experience is any indicator, we can expect the Japanese to capture a good share of what is now American-supplied trade in services, both domestically and internationally.

I would expect that in services, the Japanese will gain their comfortable 25 percent market share very quickly, largely because of their established trading infrastructure, investments, and strength in the U.S. market. Japan also has a well-established domestic service sector to build upon—a critical factor for any export offensive they contemplate.

The Japanese might do even better in penetrating the United States and global markets for services than they did in the manufacturing and products areas. That is because the very characteristics that gave them a comparative edge in the manufacturing areas—market analysis, quality control, service, customer awareness, product design and packaging--are important to the services industry and build on the competitiveness in health, training and conditioning of their workers discussed above.

The Japanese have been studying services for some time. In the 1970s, they coined a phrase for their broad-ranging approach to the service industries: "softnomics." In Tokyo today there is a government/business research institute, "The Softnomics Center," which is doing excellent research on the shift to a high-technology, information, marketing, and convenience-oriented, global service economy. This is only one of several publicly sponsored institutes dedicated to analyzing domestic and foreign markets and supplying Japanese private business with practical assistance.

Obviously the question is what should America now do to reverse this process? But we have asked this question before and people have given their advice. That little has been accomplished in the last five to ten years tells us a great deal about our political process, which is perhaps more antiquated than our economic structures.

The next question is how bad does the situation have to get before we must act to survive. I don't believe we will have to wait until the 21st century to have the answer. The competitive challenge of Japan and the other industrializing Asian nations is of "Olympic" proportions, and the only lasting solution may be to go back to the basics that make for success in other areas, especially competitive sports.

There are No Easy Solutions

National security comes in many forms and shapes. "Sputnik" made Americans aware of the Soviet threat and we put the resources and talents to work to protect our own security. We still do it and protect the Japanese as well. Hopefully, humiliation in the economic competitiveness game will sharpen our attention to what the trade "game" is all about.

The first and easiest step in a process of recovery would be to rid ourselves of the illusions about how our competitors win. The next step is to develop a competition delivery system by ridding our government of ineffectual trade coordination institutions. Finally we have to invest in people, science and practical technological applications in new ways that make us competitive. This is how the British attained empire, how America was successful, and how Japan and the other Asian countries accomplished what they have. Basically we need a better team on the playfield.

APPENDIX

CHART I

Leading Trading Partners of Selected Asian Countries (1985)

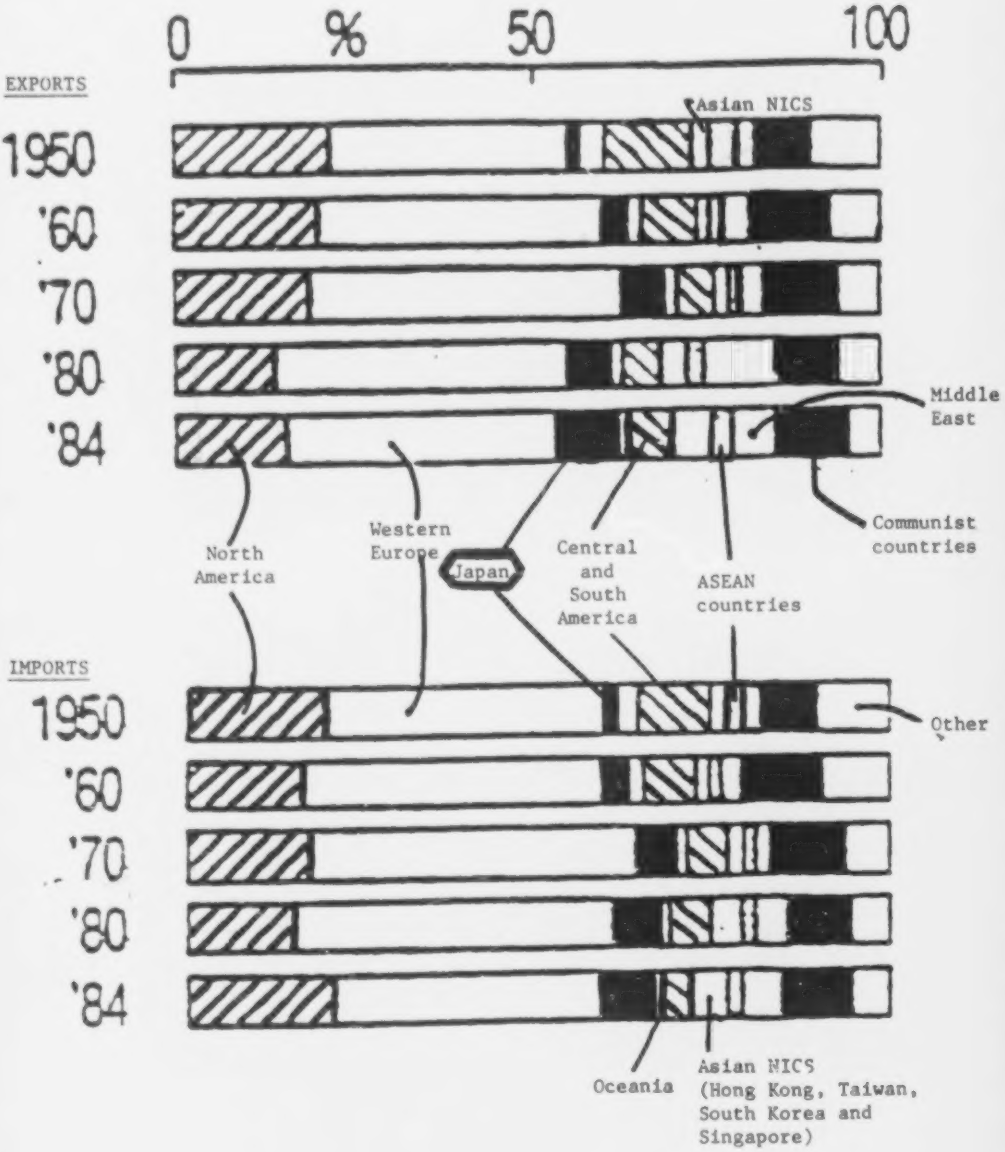
		Total[a] (US$ million)	Top Four Partners (%)							
			No. 1		No. 2		No. 3		No. 4	
China[b]	Exports	22,321	Hong Kong	26.5	**Japan**	**20.6**	U.S.A.	9.3	Singapore	3.6
	Imports	23,855	**Japan**	**31.3**	U.S.A.	14.8	Hong Kong	10.9	Germany, F.R.	4.8
Korea, Rep. of	Exports	30,283	U.S.A.	35.5	**Japan**	**15.0**	Hong Kong	5.2	Canada	4.1
	Imports	30,631	**Japan**	**24.9**	U.S.A.	22.4	Saudi Arabia	4.5	Australia	3.6
Indonesia[b]	Exports	23,950	**Japan**	**47.3**	U.S.A.	20.6	Singapore	9.7	R.T.T.[c]	3.8
	Imports	10,834	**Japan**	**23.8**	U.S.A.	18.4	Singapore	12.9	Saudi Arabia	9.7
Philippines[b]	Exports	5,390	U.S.A.	38.0	**Japan**	**19.4**	Singapore	5.9	Hong Kong	4.3
	Imports	6,069	U.S.A.	26.9	**Japan**	**13.4**	Saudi Arabia	6.9	Kuwait	6.3
Thailand	Exports	7,118	U.S.A.	19.7	**Japan**	**13.4**	Singapore	7.9	Netherlands	7.1
	Imports	9,429	**Japan**	**26.0**	U.S.A.	11.1	Singapore	7.3	Malaysia	5.8
Malaysia	Exports	15,437	**Japan**	**24.5**	Singapore	19.4	U.S.A.	13.0	Korea, Rep. of	5.9
	Imports	12,307	**Japan**	**23.0**	Singapore	15.8	U.S.A.	15.3	Germany, F.R.	4.5
Singapore	Exports	22,806	U.S.A.	21.2	Malaysia	15.5	**Japan**	**9.4**	Hong Kong	6.4
	Imports	26,278	**Japan**	**17.1**	U.S.A.	15.2	Malaysia	14.4	China	8.6

a) U.S. dollar figures are calculated according to the annual average exchange rates of the IMF, *International Financial Statistics*. b) 1984. c) Republic of Trinidad and Tobago.
Source: JETRO (Japan External Trade Organization).

Adapted from: Japan 1986 An International Comparison, Keizai Koho Center, Japan Institute for Social and Economic Affairs, 1986.

CHART II

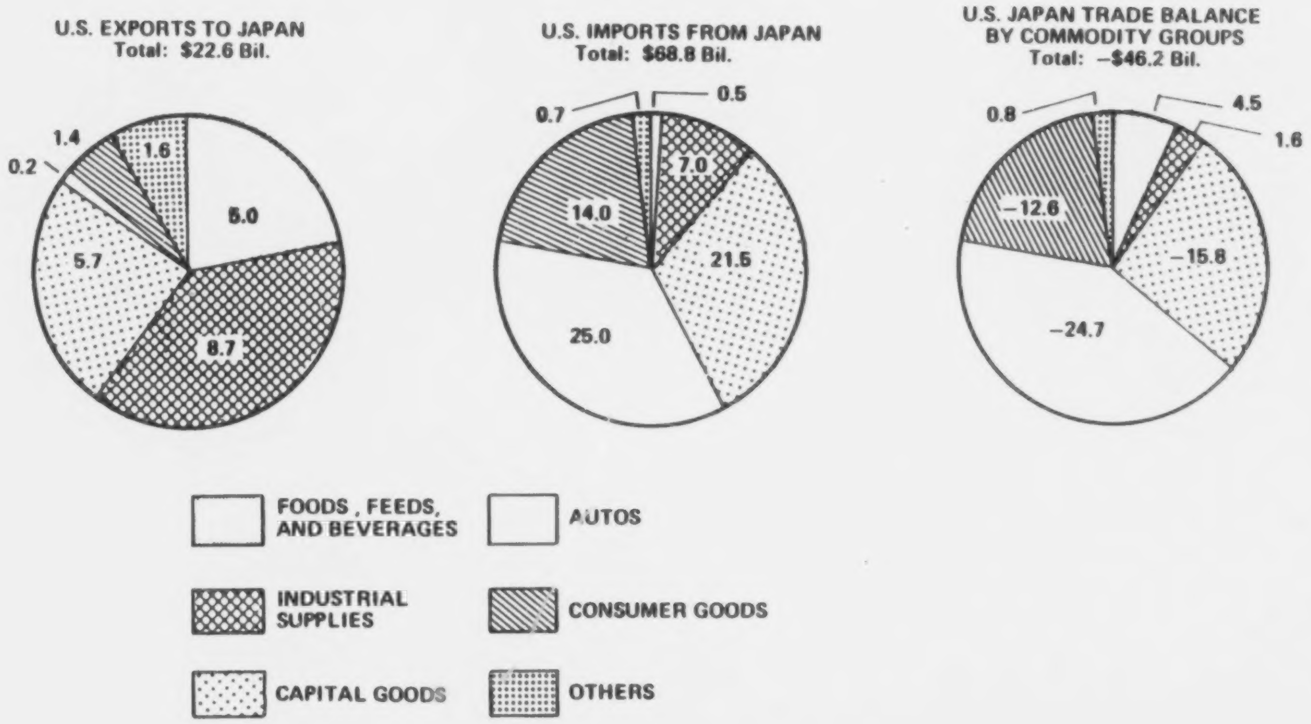
CHANGES IN IMPORT/EXPORT MARKET SHARES BY REGION AND COUNTRY



Source: Nihon Keizai Shimbun, October 5, 1986, p. 8.

CHART III

COMPOSITION OF U.S. TRADE WITH JAPAN IN 1985



U.S. EXPORTS TO JAPAN
Total: $22.6 Bil.

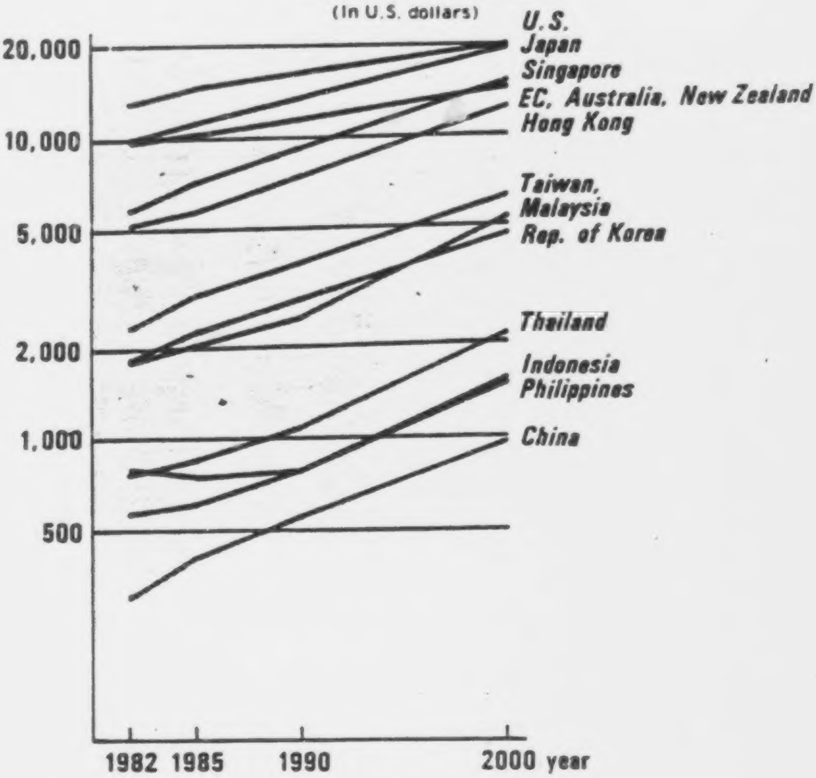
U.S. IMPORTS FROM JAPAN
Total: $68.8 Bil.

U.S. JAPAN TRADE BALANCE
BY COMMODITY GROUPS
Total: –$46.2 Bil.

Source: Report prepared by Joseph Kvasnicka, Federal Reserve Bank of Chicago, September 1986.

CHART IV

Outlook for Income Level (Per Capita GNP) in the Pacific Region



Notes: a. Scale is logarithmic.
b. Based on actual 1982 prices and exchange rates; therefore, projected figures may be affected by fluctuations in exchange rates.

Source: Japan Economic Journal, October 12, 1985, p. 14.

Mr. **Behr**. Thank you.

The last word will go to Prof. Shinichi Ichimura, who is a visiting professor at the Graduate School of Business at Columbia University and comes there from Kyoto University.

Professor Ichimura, if you will give us about 15 minutes of your thoughts, that will leave time for some questions and answers among the panel members.

STATEMENT OF SHINICHI ICHIMURA, VISITING PROFESSOR, GRADUATE SCHOOL OF BUSINESS, COLUMBIA UNIVERSITY

Mr. **Ichimura**. Chairman Obey and Mr. Behr, I thank you very much for giving me this opportunity to present my views on the United States-Japanese relations as a foreigner. Inviting foreign speakers to the hearings of the Parliament have been done in Japan, too, but it's very unusual. So I appreciate very much this unusual opportunity.

I have presented my own statement in the written form so you can look at them. The two tables I attached to my previous ones are missing, but maybe you can get them from the secretaries, but I will try to summarize the major points.

At the moment, in 1985, if we take the American GNP as a percentage of the total GNP of all the Pacific Basin countries, it is something like 58 percent. The Japanese share is 21 percent.

Now if we extrapolate according to some estimates to the year 2000, your share would be something like 54 percent, 3 to 4 percent down. The Japanese share will be something like 23 percent, about 2 percent upward.

Well, that's not much of a change, but in the absolute amount and also in terms of per capita income it has a lot of implications, and other Asian countries are also coming up.

In terms of per capita income, in the year 2000, if we exchange the yen to dollars at the current exchange rate, the Japanese per capital income will be higher—it will be significantly higher than the United States per capita income. That's the picture we should anticipate.

Now with that kind of future in our minds I would say the following: What would be the most fundamental problem between the United States and Japan? I would summarize it in one sentence; namely, Japan has now become the No. 2 economic power in the Western community, but not yet attained the solid status of a powerful ally of the Western alliance in the East.

The basic issue to us is how to establish the real trust and friendly association between us in which we could solve the problems not so much by bargaining but, as we say in Japan, by jokes and laughs over the dinner table. In order to attain such real trust between two nations, we seem to have to do other things. I will divide my arguments into several sections.

The first section is the short-run adjustment problems. Professor Hugh Patrick already discusses that, but I would say the following: On the Japanese side, the Japanese growth rate must be pushed up by all means, by increasing domestic investment mainly and by investing abroad. I don't agree with the view that Japan should increase domestic consumption so much. This is happening slowly and that will grow as time passes by.

We are living basicially in a world short of capital. If the United States cannot offer capital to the rest of the world, Japan should. So we cannot afford to reduce our saving. We should keep our saving rate as it is.

The Japanese economy is basically in the stage of investing abroad as the United Kingdom was earlier and the United States was some decades ago.

On the U.S. side, the United States should reduce its fiscal deficit and take all the measures to increase the domestic savings. We are living in a world, as I said earlier, short of capital. There is no reason to reduce savings in any industrialized country. It should be increased. And at the same time, the investment should be increased. The objectives of the U.S. side should be to reduce the real interest rate, which hasn't come down yet, and reduce also the return to financial capital but increase the return to physical capital investment. It is a symptom of unsound economy and nation that financiers prosper and those who sweat to produce suffer. As an economist, I dare say, resource allocation in this nation is wrong.

The exchange rate will sooner or later play a significant role in narrowing down the trade gap. It has taken time but it will work. The reason why it didn't work soon enough as we hoped for is that it has been out of proper alignment too long. But I trust it will work and in Japan we see already many signs to downward adjustment of economic growth.

Now second, why we get into conflicts so often. It seems to me that sometimes we move to the danger points—in the United States in particular—sometimes we move to the danger points in Japan, too. I would say the American Congressmen and American journalists get excited (a) when the U.S. unemployment rate exceeds 7 to 9 percent. If you examine when the arguments get heated, always the unemployment rate in the United States is high.

(b) When the Japanese share of the United States market of a given product, like automobiles, exceeds 15 to 20 percent. There seems to be a certain limit that the share of the market is permitted to foreign producers.

(c) When the proportion of exports in Japanese production of a given product, say automobiles, approaches 50 percent, then Americans say, "Why don't you move your factories?"

(d) When politically influential industries, say textiles in the earlier example, are seriously affected. Why?

(e) When Japanese enterprises begin to compete in strategically important industries. That's understandable.

Well, when we should not get excited we tend to be excited and the Japanese agriculture is highly protected, but when people attack the issue or rice the Japanese farmers stand up, as they did in the feudal days.

Third, there are some underlying long-run problems and this is probably the most fundamental one. Many other speakers already have spoken on that. I will try to point out two simple facts.

In 1978, the total number of scientists and engineers in Japan who were engaged in active research and development work was 400,000. In the United States it is 541,000. I don't have the number at the moment. In 1985, probably the number in Japan is bigger than the United States.

The amount of research and development expenditure in the United States, including military, in 1983, $87.7 billion. In Japan, $27.4 billion. It is about one-third. Nevertheless, the U.S. side includes the military research and development expenditure so that if you pay attention only to the civil part perhaps the number is much closer, and given the same number of scientists we should expect that technical progress in Japan will be very quickly catching up with the technical progress in the United States.

(b) Real capital formation per capita in Japan is about 20 percent above now the same figure in the United States. If we concentrate in the private capital formation, perhaps the difference is more significant.

In the future, then, the Japanese workers will be equipped with more modern capital equipments. Under these circumstances, unless the U.S. Government or industries do something about this fundamental trend in the increase in productivity, the trade conflicts will not go away.

We may be able to solve it for one time, but it will come back. The consequences will be a steady decline in dollars vis-a-vis yen, as U.K. sterling has been vis-a-vis dollars and yen. This seems to be the kind of situation that we should expect in the rest of the 1980's and the 1990's. I have made my own prediction and those are in the tables.

Fourth, there is a serious problem, as other speakers mentioned, in differences in policymaking styles and there are some psychological problems. On these scores Japan should be blamed more critically. The attitudinal difference is rather significant. Japanese politicians and government officials in particular tend to respond to American requests at the lowest level and at the slowest pace. This breeds resentment on both sides. Japan often feels that the United States is demanding endlessly and make Japan a scapegoat for American domestic problems.

But on the other hand, many Americans regard Japan as the cause of their misfortunes and bad guys who always misbehave and push out the excellent American industries into the Pacific Ocean.

What to do here is to start negotiations early, anticipating the problems, try hard to reach compromises as quickly as possible, and then implement policies promptly with proper regard for public relations.

The Maekawa Report has mentioned a number of appropriate policies which we, as economists, advocated a long time ago, but how to implement them is a very serious problem.

When we come to reach some agreements at the internal levels, it is usually on the Japanese side which is very slow in acting.

In agricultural production there are regional programs that ought to be played by the Government on both sies. I will not go into those today.

Finally, I would like to mention what king of role Japan should be playing in the Pacific Basin region. I will list them very quickly.

Japan should be a pace-maker of economic development in the Asia Pacific region, as well as the United States.

Japan must be a caretaker or troubleshooter at least in economic affairs, as the United States is both in economic and political affairs.

Japan has to take initiatives in appropriately restructuring the manufacturing industries in the various stages of development of the Asian countries.

Japan has to paly a role in mediating the conflicting interests between Asian countries and Japan and the United States and also amoung countries in Asia. For this purpose Japan should prepare the medium- and long-term programs for Asian development, as she did for her own economy.

Japan should be ready also to be a mediator between developed countries and developing countries and try to show a model case in Asia in solving the North-South problems. For this purpose, a forum like the Pacific Economic Cooperation Committee—Professor Hugh Patrick and I are both national committee members—should be strengthened and should be brought up even to the level of congress of some kind in the near future. This forms must be a place for mutual debate on the major international—rather than bilateral—issues not at the governmental levels but among selected groups of intellectuals, businessmen, government officials and politicians.

The United States, Japan, Canada, Australia, and New Zealand relations must be strengthened in order to coordinate all the major policies in the Pacific Basin countries. If we take these countries' GNP together, they occupy now about altogether 85 percent in the year 2000 and also in 1985.

For this purpose Japan should not antagonize, however, the socialist countries. I will omit the rest of the statement.

The United States and Japan should strengthen the mutual exchange not only in economic matters but in noneconomic spheres like culture, science and technology, and other academic and intellectual activities.

By doing all these, Japan could play a role and will be supplementary and complementary with the United States in solidifying the Pacific Basin community. The United States and Japan will be demonstrating to the world the best way of resolving the North-South problems and to follow and suggest other countries to follow this East Asian model or Pacific Basin model rather than China or India models.

The extent to which China will be attracted to this idea, the alliance of the United States with Asian countries will be stronger and the resilience against the Soviet-type of communism will be solidified. Thank you very much.

[The complete statement of Mr. Ichimura follows:]

Statement on US-Japan Relations

Shinichi Ichimura
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The most fundamental problem between the United States and Japan may be expressed in one sentence; namely, Japan has now become No.2 economic power in the Western Community but not yet attained the solid status of a powerful ally of the Western Alliance in the East. The basic issues are how to establish the real trust and friendly association in which we could solve the problems not by bargaining so much but rather, as we say in Japan, by "talks and laughs over the dinner tables". I believe that we are moving in the right direction but too slowly.

1. Short-Run Adjustment Problems

a) Japanese growth rate must be pushed up by increasing domestic investment as well as investment abroad. I do not agree with the view that Japan should significantly increase domestic consumption. This will happen gradually. The Japanese economy is in the stage of investing abroad, as the UK was in the 19th century and the US was some decades ago.

b) The United States should reduce its fiscal deficit and take all the measures to increase the domestic savings. We are living in the world short of capital. There is no reason to reduce savings in any industrialized countries. The objectives should be to reduce the real interest rates and real rate of returns to financial capital in the United States. It is a symptom of unsound economy and nation that financiers prosper and those who sweat to produce suffer. As an economist, I say with no hesitation, resource allocation in this country needs improvement.

c) The exchange rate will sooner or later play a significant role in narrowing the trade gap between the US and Japan, but it will take a longer time than most economists thought or hoped for. The reason is that the exchange rates were out of their proper alighnment too long. But it will work. In Japan we see already many signs to downward adjustment of growth rate and increase in overseas direct investment.

2. Danger Points In Trade Conflicts

The trade conflicts are often triggered by hitting some "danger points" in the two nations. In the case of the US-Japan relations, they are:

a) When the US unemployment rate exceeds 7-9 percent;

b) When the Japanese share of the US market of a given product exceeds 15-20 percent;

c) When the proportion of exports in Japanese production of a given product, say automobiles, approaches 50 percent;

d) When politically influential industries, say textile industry in the previous case, are seriously affected;

e) When Japanese enterprises begins to compete in strategically important industries.

3. Underlying Long-Run Problems

The trade gaps were widened to some extent by the closedness of the Japanese markets in the past. Although there are still a number of non-tariff barriers in the forms of too stringent standards and permits, the Japanese tarrifs can hardly be said to be high any longer. It is also observable that many of Japanese commodities are sold more cheaply in the United States than in Japan, which may give one the impression of dumping. But there are many discount houses in Japan, where the prices are far below the prices of established department stores. It should be a matter of investigation how much practice of this "dumping" is realy to be blalmed.

More important are the underlying long-run causes of trade gaps. They are the fact that two countries' real productivities are widening the gaps. A number of academic studies in the US and Japan confirmed these facts.

Simply two facts may be pointed out:

a) The number of scientists and engineers engaged in Research and Development in Japan is almost the same as in the US: (400,000 in Japan, 541,000 in the US in 1978), and the R & D expenditure in the US, including military one is $ 87.7 billion in 83, whereas that in Japan is 27.4$.

b) Real capital formation per capita in the Japan in 84 is aabut 20% above the same figure in the US.

Unless the US government or rather industries do something about this fundamental trends, the trade conflicts will not go away. The consequences will be steady decline of Dollars vis a vis Yen, as UK Sterling has been vis a vis Dollars and Yen. This seems to be the kind of situation that we should expect in the rest of the 80's and the 90's. My own prediction of the Pacific-basin countries are in the attached tables.

4. Policy-making Styles and Psychologial Problems

a) Attitudinal differences: Japanese politicians and government officials tend to respond to American requests at the lowest level and slowest pace. This breeds resentment on both sides. Japan often feels that the US is demanding endlessly and made a scapegoat for American domestic problems or politics US industry, whereas many Americans regard Japan as the cause of their misfortunes and bad guys who always mishave and push out the excellent American industries and push them out to the Pacific ocean the way they are remembered the Pearl Harbor. What to dod here is to start negociations early, try hard to reach compromises quickly and then implement policies promptly with proper regard for public relations.

b) Protection of Japanese agriculture

c) Reginal considerations

d) Japan's industrial policies to be reconsidered--implementation of Maekawa report.

5. The Role of Japan in the Pacific-basin Region

a) Japan is a pace-maker of economic development in Asia-Pacific region;
b) Japan must be a care-taker or trouble shooter at least in economic affairs;
c) Japar has to take initiatives in appropriately restructuring the manufacturing industries in the various stages of development of Asian countries;
d) Japan has to play a role in mediating the conflicting interests between Asian giants like China & India and other Asian countries or for that matter between any countries in Asia. For this purpose Japan should prepare the medium and long-term programs for Asian Development.
e) Japan should be ready also to be a mediator between developed countries and developing countries and consciously make effort to demonstrate a model case for resolving the North-South problems without causing political confrontation. For this purpose a regional forum like the Asia-Pacific Economic Cooperation Committee should be strengthened and should be brought up even to the level of congress of some kind in the near future. This forum must be a place for mutual debate on the major inter-national--rather than bilateral--issues not at the governmental levels but among selected groups of intellectuals, businessmen, overnment officials and politicians.
f) The US, Japan, Canada, Australia and New Zealand must strengthen their mutual cooperations and understandings in order to realize the above-mentioned objectives.

g) For this purpose also Japan should not antagonize the Socialist countries like the Soviet Uniion, North Korea and Vietnam beyond the minimum and the unavoidable and try to maintain the friendly relations in science, culture, and economic transactions without losing the basic principles of reciprocity and human rights.
g) The US and Japan should strengthen the mutual exchange in non-econmic

spheres like culture, science and technology and other academic and intellectual activities.

The favorable effects of Japan playing such a role will be:
a) Japan will be complementary with the US in solidifying the Pacific-basin Community;
b) The US and Japan will be demonstrating the world the best way of resolving the North-South problems is to follow this East Asian Model rather than China or India.
c) The extent to which China will be attracted to the idea, the alliance of the US with Asian countries will be stronger and the resilience against the Soviet-type of Communism will be solidified.

(1986.12.9)

Table A : GDP and Its Growth Rate in Asian Countries

	Growth rate %	GDP		Growth rate %	GDP	
	85-90	90	share in Pb	90-2000	2000	share in Pb
High Income Countries:		6,099	87.8		7754	85.3
USA	3	4,011	57.7	1 - 3	4889	53.8
Canada	3	374	5.4	2 - 3	479	5.3
Japan	4	1,473	21.2	3 - 4	2078	22.9
Australia	1	212	3.1	2 - 3	271	3.0
New Zealand	1	29	0.4	2 - 3	37	0.4
Asia NIC's	6	270	3.9	3.5-5.5	423	4.7
Korea	7	125	1.8	4 - 6	204	2.2
Taiwan	7	86	1.2	4 - 6	140	1.5
Hong Kong	3	38	0.5	2 - 4	51	0.6
Singapore	2	21	0.3	2 - 4	28	0.3
ASEAN		220	3.2	3.2-4.2	320	3.5
Malaysia	4	41	0.6	4 - 5	64	0.7
Thailand	4	53	0.8	3 - 4	75	0.8
Indonesia	2	94	1.4	3 - 4	133	1.5
Philippines	1	34	0.5	3 - 4	48	0.5
China	5	360	5.2	4 - 6	586	6.5
Pacific		7,949	100.0		9,083	100.0
South Asia:		304	4.4		447	4.9
India	4	242	3.5	3 - 5	358	3.9
Burma	3	8	0.1	2 - 4	10	0.1
Sri Lanka	2	5	0.07	2 - 3	6.4	0.07
Pakistan	6	39	0.6	4 - 5	61	0.7
Bangladesh	4	14	0.2	2 - 4	19	0.2
Nepal	2	2.5	0.04	1 - 2	2.9	0.03
Asia sub-total		2,627	37.8		3,854	42.4
EC	2.5	2,805	40.4		3,590	39.5

Table B : Perspective Income Levels in Asian Countries

	1985 GNP pc	growth %	1990 GNP pc	growth %	2000 GNP pc
High income countries					
USA	14,760	2.0	16,296	1.3	18,543
Canada	11,490	1.8	12,562	1.6	14,723
Japan	11,310	3.1	13,175	3.1	17,879
Australia	11,930	-0.3	11,752	1.4	13,505
New zealand	8,140	0.5	8,346	1.8	9,976
Asian NICs	3,060				
Korea	2,330	5.4	3,031	3.6	4,317
Taiwan	3,160	5.5	4,130	3.7	5,939
Hong Kong	6,110	1.6	6,615	1.8	7,907
Singapore	7,180	0.6	7,398	2.0	9,018
ASEAN	780				
Malaysia	2,110	2.2	2,353	2.4	2,983
Thailand	880	2.0	972	2.0	1,185
Indonesia	640	-0.2	634	1.7	750
Philippines	740	-1.2	697	1.8	833
China	400	4.6	501	4.0	742
Pacific mean	4,350				
South Asia					
India	265	2.0	293	2.3	368
Burma	182	1.0	191	1.0	211
Sri Lanka	361	0.2	365	0.7	391
Pakistan	386	3.1	450	2.0	549
Bangladesh	132	1.5	142	0.6	151
Nepal	160	-0.5	156	-1.0	141
Asian mean					
EC	10,500	2.4	11,820	2.6	

Notes: The growth rates of GDP are taken from Table-27, and the rates of growth in poplation are taken from the World Bank Development Report, 1986.

Mr. **Behr**. Thank you, very much.

In an attempt to try to sum up the various points of view that we have heard on this tremendously complex issue, I would like to ask each of the panelists if they would think about the most important priority that should occupy Congress next year.

I would like to propose to the panelists that they think about three choices and ask them would they rather have Congress spend its energy on trade reform—than is to say, seeking for ways to help the administration or cause the administration to seek more open markets in Japan and Europe; or second, would they rather have Congress concentrate on reducing the Federal budget deficit; or third, would they like to see Congress concentrating on efforts to improve the competitiveness of American companies and the education and the training of American employees; or you may come up with a fourth.

Let me start with Professor McCraw, the top priority for Congress next year.

Mr. **McCraw**. I think the top priority has to be the deficit. We are so sick of hearing about this that again we've become desensitized to it. Our minds have developed calluses like the soles of our feet.

But until something is done about that, which I regard as a kind of national shame—one of my colleagues recently—and this is a Harvard Business School man, not some person in a liberal Democratic think tank. One of my colleagues at the Harvard Business School said this is the most fiscally irresponsible administration in American history.

Now as a historian, I cannot think of another one that rivals it. And it's not just the administration; it's Congress as well.

I think those numbers I started with are simply beyond belief. If we turned back the clock 10 years ago and asked could this happen, we would say no. So I think that has to come first.

That's not to say the other two are not important or a very close second or third. To use Mr. Morse's sports analogy, we're talking of gold, silver, bronze medals here and often the gold is by a tenth of a second or a hundredth of a second if it's a dash event. But I think this fiscal deficit, in the course of American history, 200 years as a nation, is simply unprecedented and is a national disgrace.

Mr. **Behr**. Professor Patrick.

Mr. **Patrick**. I share those views. Clearly, without reducing the fiscal deficit, we cannot solve the problem of competitiveness and cannot achieve a constructive mode of trade reform. So the first thing to do is to get our own macroeconomic house in order.

It is not just on the fiscal side. I think we probably could do more on the monetary side as well, but they go hand in hand. Reduction of the budget deficit is an essential condition to restore our competitiveness.

Part of the reason we lost our competitiveness internationally was that we gave the rest of the world the gift of an overvalued dollar. We made it incredibly easy for everybody else to sell here. We have now made it very hard for ourselves because once they are here an entrenched it is going to be very difficult to restore our own competitiveness.

I think the trade reform issue depends on what you mean by trade reform. If we are talking about enabling legislation to push ahead on the GATT negotiations and a stance that moves that way, I would say that certainly is high priority. Nonetheless it ranks behind the budget deficit.

I do not think there is a quick fix to improve competitiveness in very specific ways. To think that Congress and the executive branch are going to legislate improving competitiveness would strike me as naive and wishful thinking.

Clearly, we can create a business environment in this society, such as in education, which would be much more conducive to improving competitiveness in the long run. That require various kinds of institution building areas. Not only have we messed up on the budget deficit but in our attempts to solve the budget problem we have reduced sharply our investment in the future in order to maintain our consumption in the present.

By restoring some sort of degree of sanity—you didn't use the word "insane" but I will use the word "sanity"—and get the budget in line, then every thing else will be able to follow from that—not easily, but without first solving the budget deficit, we will not be able to resolve constructively our other problems at all.

Mr. BEHR. Professor Thayer.

Mr. THAYER. I agree with our two earlier speakers that the budget deficit problem is the greatest problem that we face, but I don't really have great deal to add to what they have already said.

I would like to comment on the other two problems. No one can speak out against improving competitiveness. But competent management on what the Government should be doing to heighten competitiveness. How does the Government heighten international competition without changing domestic competitiveness? In the past, the Government has been willing to provide subsidies to support a weak domestic industry. Is the Government now willing to toughen the lines of domestic competitiveness, realizing that companies will fail if they do so. I think not. Before we go much beyond strengthening the educational system and supplying R&D funds—the traditional area where Government is seen to have a role—I want to think long and hard.

I spent the last 2 weeks working on a paper on the style of negotiations between Japan and the United States. There are things that can be done to improve our way of talking with each other.

I frequently see in newspaper articles describing the new trade legislation that we are going to "give our negotiators more power." I guess that's important for a new trade round, but I don't think that's really going to resolve the outstanding questions between Japan and the United States. I think the American negotiators now really have as much power as they need.

Over the last few years in Japanese-American trade negotiations, there's almost been a total decentralization of the two nation's negotiating teams. Each U.S. agency negotiates on its own behalf. No one requires all the agencies to meet and reach agreement on what is important and what is not.

The same thing is going on in Japan: Each ministry has its own foreign policy, which conflicts with the policy aims of other ministries. Many of the sparks that are being thrown off in these negotiations do not come from friction between the Japanese negotiators, and the American negotiators. Rather, the sparks emanate from within the two negotiating teams—the American negotiating team and the Japanese negotiating team—as each representative fights to have his agency's position recognized as a national position.

I think there's much room for bettering the ways for the two nations to talk to each other.

Mr. **Behr**. Professor Morse.

Mr. **Morse**. Well, I think the Congress really has to reestablish itself and not be used as a simple whipping boy by the executive branch that it has been used as over the last decade. Whenever it's impossible to negotiate, and our negotiators have never really done anything substantial—we've been negotiating beef and oranges for a decade—and the K Street entrepreneurs have made a business out of it. Congress has no track record in enlightened trade legislation with Japan. So I don't think we can open foreign markets until we have some way to open foreign markets. The record in the trade reform area of foreign governments is dismal.

On the question about the Federal deficit. In this country we change economic policy by politics, and the next chance we will have to change the trade deficit will be in 1988. I don't think there's much that Congress can do to change that situation right now and I think that it's much better to focus on the things that are in the range of possibility.

I think where the Congress can show initiative and does have the instruments for policy is to work and come up with—even though we have not come up with a policy thus far, it does not mean we are incapable of coming up with a policy—is to work with the instruments we have to start rebuilding the system for a longer term battle.

The trade deficit is a short-term problem and opening foreign markets is also perhaps even less short term because we are trying to open it in areas where we know we are no longer competitive anyway.

So I would focus on the longer term, more substantial things that Congress can achieve.

Mr. **Behr**. Professor Ichimura.

Mr. **Ichimura**. Reducing the fiscal deficit is No. 1. That would bring out the very good effect on interest rates and that would create more investment domestically here to increase productivity which makes the American industries more competitive, and so that the foreign markets will be open more to American competitors.

I would like to add two more important things. One thing is the United States Government must negotiate not only just with Japan but with other Asian countries in mind because other countries' exchange rates are fixed vis-a-vis the United States dollar. This has got to be changed. Otherwise, the Japanese industries will set up the factories in other Asian countries and export from those bases.

Second, the education in the United States has to be improved. The primary, secondary, and higher levels. The graduate schools are outstanding. The education has to be improved. Otherwise, the American workers will not be as efficient as the Japanese workers.

Mr. **Behr**. Let me return to Congressman Obey or Congressman Abercrombie to see if they have any further questions.

Representative **Obey**. Well, I've got one question and then see if Neil has a question and then I would like to make a short observation in closing.

My question would simply be this. We have heard I think differing views here from two of our panelists on what kind of political leadership we are likely to see in Japan down the line. We have heard a lot of suggestions that Japan may be serious about restructuring its economic strategies.

I guess my question is this. Given Mr. Thayer's picture of what future leadership, in his judgment, might look like in Japan, an assessment with which Mr. Morse disagrees, what does that really tell us about the real ability or willingness of the political system to try to restructure that strategy and what are we to conclude from the recently announced tax changes which, while they would reduce the tax rate, would impose additional sales taxes which would seem not to be a device by which you would increase consumption in that economy?

What does that tell us about whether we are likely to get this new structure? Any of you.

Mr. **Ichimura**. The present tax reform, if it goes through, will reduce the saving rate because it's going to abolish the preferential treatment for some savings, and will improve the income distribution which will increase consumption also. So it will have a favorable effect on domestic expenditure, but not very much.

It will, however, have a significant influence on the fiscal expenditure if it succeeds to collect more revenue.

Mr. **Morse**. My sense is that the big problem, whether in fact domestic demand in Japan goes up or down doesn't mean much for the United States unless we are in the market. Our companies are not in the market, and they don't have much intention of getting there.

So I don't think it's going to really change the—what it does I think in a sense is just make the Japanese more competitive for those who are in the market and that means they will be more competitive externally.

Mr. **Patrick**. I would like to make two observations. First, who is Japan's Prime Minister over the next 15 years is probably much less important than the fact that the LDP will continue to be in power so far as we can tell, and that will give a consistent, stable, some might say inert, policy approach.

The second is that Japanese restructuring is likely to come about not because of United States pressure, not because of political leadership, but because changing economic circumstances will force Japanese policymakers to take new policy. When they start having unemployment rates of 4 or 5 percent, which are going to be horror figures in Japanese minds, when they start having high rates of bankruptcy, when the economy is growing very poorly, they are going to have everybody on their backs to do something. And I think that is when we will see a restructuring of government policy for the economy. They will perceive Japan cannot grow through exports. That gift we provided the last 5 years of the overvalued dollar has ended and the yen will continue to be strong. So if they are to solve their domestic economic problems, which will become political problems, it will have to be through domestic restructuring.

And I think, by and large, throughout the next 15 years, the Japanese Government, the policymakers, the politicians, are likely to be responding to economic forces rather than having some timetable based on great political leadership. But those economic forces are going to be very powerful.

Mr. **Morse**. I wouldn't necessarily count out the fact that one has to look at the ruling party to look for the future leaders. I think that we are going to see businessmen and other people in Japanese society taking on great responsibility and filling cabinet positions and doing things that the Japanese so far haven't really tried to consider.

So I wouldn't necessarily go on the assumption that one extrapolates in a straight line out from the past what we will see in the future.

Mr. **Behr**. Congressman Abercrombie has a question.

Representative **Abercrombie**. Less a question than an observation based on your request about congressional priorities, and I think the chairman touched on it in his remarks.

We want to talk about Japan in the sense of an elite trickle-down theory of change. You can say the same thing with education in the United States. There is one thing in the context of all the remarks that have been made this morning. There has to be and has not been to this point, except by some efforts I know by Senator Simon, on language education, foreign language education, and Asian studies.

I come from a State that should be leading and in certain ways does, and yet, as a former higher education chairman in my own State, I am sick and tired of hearing all the rhetoric about the necessity for Asian studies, the necessity of foreign language support. We do not have a national program, let alone State programs, worthy of the name in any place in the United States.

One thing I would like your observation on, even though it may add to the deficit—and I think of it more as an investment—if there should be a national program with the same kind of emphasis that was a response to the Sputnik situation technologically—the same kind of emphasis—a national program in language education and in Asian studies worthy of the name. That is to say, providing a broad-based study program from the grade schools right on through across the country, and that this has to be made available as an investment by the Government of the United States in a program directed toward the Pacific area—not Japan in particular. I am talking about the Pacific.

I don't care whether it's military or whatever it is. You hear all about NATO all the time. I tell you right now from my point of view, the Strait of Malacca is infinitely more important. People don't know how to spell it. They don't know where it is. They haven't any idea what it's all about. I'm sure the good professor from Japan knows that the industrialists and other political leaders in Japan know where the Strait of Malacca is.

Minus this, I think much of what we are talking about will remain in the hands of elite discussions and panel ruminations. I just see heads nodding over there so I think that is assent.

Mr. **Morse**. Well, I think your point is very good and I think it's necessary for two reasons. One, as you know, the ethnic composition of our country is changing and we really owe it to the Asians in this country that their heritage is better understood in our total understanding of international relations, and that's not covered in our schools, in our language programs, and in our textbooks.

The second thing is that it's a fundamental necessity, given the fact that our trade, the future economic area of the world for the next 50 years, is going to be the Pacific Basin. If we don't know about it, we are at a disadvantage.

So I think for a multitude of reasons I think you are perfectly correct.

Mr. **Thayer**. Let me just step in here for a moment. We have been talking about competitiveness. One of the areas where we do battle is in the collection and dissemination of information. We don't even catalog more than 20 percent of the Japanese technical literature that is published. And our translation program is even more modest.

Everything that American scholars write gets cataloged in Japan. There is a Government office that will make it available to anyone who wants it, free. Just tie your modum into the Government computer banks. It's all there and it's available for you.

We Americans don't even know what the Japanese are interested in much less what conclusions they have reached.

Mr. **Patrick**. These words are obviously close to the heart of the particular set of interest groups we represent, so we all obviously are in favor of support of Asian studies and languages and so forth. That's our business.

However, I think the basic problem in education in the United States is not that. It is that we need to have a functionally literate population that also knows how to use basic mathematical tools and computers; our society does not have those skills sufficiently and I think that is the big problem for us. Certainly we need undergraduate and graduate training on the Pacific Basin and certainly language training, but it is also certainly training the people who are the great majority of our workers how to be effective workers, Our educational system has been letting them down; we are going to be further and further behind in our ability to compete simply because our educational system right from the beginning on does not do as good a job as it should.

Representative **Obey**. Well, I would like to just make one comment in summary and what I would really like to do is just answer Peter's question from my perspective.

You have two sets of questions. Which of the three areas you mentioned is most important? Then you have a second set of questions. Which is, nonetheless, most likely to be attacked? You don't necessarily get the same answer to both questions because in the political system, the political system attacks problems that it has the most ability to attack at the moment and the political conditions or other conditions sometimes limit your choices.

I have no doubt that the deficit is the item that Congress would most like to tackle and I think that's true of members in both parties. The problem we have is that we have a political reality that there is not a chance of a snowball in you know where of doing that effectively without the cooperation and agreement and consent of both branches of Government, the Congress as well as the executive branch. And as long as revenues are left out of the components listed for dealing with that problem, we are not going to see much by way of a real opportunity to deal with the budget deficit.

I do think under the new speaker—I heard Jim Wright's comments at the caucus after he was nominated to the speakership 2 days ago and I would say that his desire to attack the deficit is not just of normal intensity. I think he has an absolutely burning desire to attack that issue. I think he also has a very hot desire to attack the trade issue. So I think we will see both of them attacked with vigor by him and by the House, at least under his leadership, if we get the slightest inkling that we have a chance to deal with the budget question as well as the trade question.

If we don't get that signal, then you are going to deal with the only target of opportunitiy that you have politically, and that remains the trade area. And at this point it's an open question whether that will be dealt with constructively or not.

I would say that, given the fact that we now have a majority of Democrats in both Houses, one might expect that the easiest thing for that Congress to do would be to attack some of the items named by the panelists to increase productivity, especially by buttressing education. I think we have to face the fact, given the resource limitations because of the deficit, that is not likely to happen, although that institutionally would be the easiest to do in the Congress based on nothing else would happen.

I would also observe that—I don't remember which panelist made the comment, but I do believe that we get so used to talking about productivity in terms of the public sector that we forget that most of the decisions that are made—the public sector can set the framework and set the tone, but most of the decisions that will determine what happens to our productivity are going to be made in the private sector.

I recall Lou Branscom from IBM who testified before a productivity task force of the Budget Committee which I chaired back in 1980. I recall the testimony he gave at that time which made quite clear that it is the private sector which is going to have to most specifically face up to that problem and I think that they are doing it to some extent but not to the extent that is necessary in order to really make the difference.

Just a personal observation, given the references to Sputnik today. I wouldn't be here if it weren't for Sputnik because after Sputnik you had something called the National Defense Education Act, and under I've forgotten which title at that time—I thought it was title IV but it's changed so many times I don't remember—but under the NDEA I did get a fellowship to study Soviet affairs. I also studied the Soviet language. Then I got sidetracked into politics, so I lost the language, given the 25 years that I wasn't able to use it or lost most of it anyway. I can say hello, how are you. That's about all I remember after 25 years.

But I think it is crucial for us domestically to focus on education both in terms of the intensity of education, support we give teachers, the way in which schools are organized, and certainly the degree to which we as a society encourage people to be outward-looking in terms of the curriculum which we offer our kids.

I would like to be more optimistic on that subject, at least in terms of the financing of it, than I am. I come from a State which ranks among the top five in expenditures per capita for elementary and secondary education. I have been appalled that the center of gravity in the political debate in that State has not been how we should strengthen education but how we should reduce our expenditures in education.

I don't think it's any accident that my State also ranks at the top in terms of SAT scores. I kind of think that what you put in the system is reflected to at least a pretty significant degree in what you get out of it. And I am not convinced that this society is going to remember that lesson over the next 10 years.

Let me thank all the members of the panel who participated. We've gone a little over, but that's normal in congressional hearings or activities of any kind. I want to especially thank Peter Behr not only for his service as moderator today but for the generally thoughtful pieces he's written through the years on this subject and many others. Thank you again. [Applause.]

Our second panel deals with the emerging new competition in the financial services industry. One of the national consequences of Japan's enormous trade surplus is the rapid accumulation of investment capital in the hands of Japanese corporations, banks and private investors. That enormous pool of liquid capital must be deployed around the world to earn a reasonable rate of return. That reality makes Japanese financial firms major players in world capital markets.

Understanding the nature of that challenge is supposed to be the basic subject for this next session. To moderate this session we are fortunate to have Lionel Olmer, former Under Secretary of Commerce for International Trade, and now a partner in the law firm of Paul, Weiss, Rifkind, Wharton & Garrison. Few past or present public officials, in my judgment, are as knowledgeable about Japan and we are fortunate to have the benefit of his insights as the moderator of this panel. I hope that in addition to moderating, he will also offer some comments and thoughts of his own and I welcome Mr. Olmer here as well as our panelists.

Panel 2.—Lionel Olmer, Moderator

Mr. **Olmer**. Thank you, Mr. Chairman. It's a pleasure for me to be here. It's been a while and it's nice to be back.

I listened to most of this morning's session and found it informative and in many respects instructive both for some things which were said, some things which were not said, and for many things with which I wish I had time to disagree.

You have asked this panel to explore the issue of Japan's rise as a financial superpower and the implications for the United States both domestically and internationally and for the Pacific Rim as well. That's a tall order indeed.

It seems to me as the starting point, we cannot or should not separate the issue of financial superpower status in isolation form the rest of what makes a nation competitive—competitive in world markets, be they in manufacturing or in any variety of services. Nor should we separate the issue of financial superpower status from the development by the United States of a coherent policy toward the Pacific Rim Nations.

These days the word "competitiveness" has taken on a life of its own and it is soon to become almost a religion. Yet as I have read the examination of "competitiveness" in various forums, listened to many debates and read many reports, I am concerned that there may be an elimination or lack of adequate consideration to financial services in the debate about competitiveness. The United States today does have an enormous or at the very least a considerable comparative advantage over every other nation in the world and most specifically Japan and the Pacific in terms of the sophistication of the financial services that it offers.

That competitive advantage could go the way of other industries that have lost their edge in world markets unless we take care—take care within our country and take care within the negotiating process to continue exerting the kinds of pressures on Japan and other nations that are required to assure the even playing field that we have so long sought in other areas such as manufacturing.

Now the world of finance has not yet become my oyster, Mr. Chairman, but in the world of manufacturing we refer to capital as the lubricant of world trade and indeed the key to the competitiveness of various industries.

Surely, financial services have beome an institution pretty much an end unto themselves. So I would say that the search for coherence in U.S. policy toward the region of the Pacific as a whole must not just talk about manufacturers or trade in services but look at the totality, underlying which is clearly capital resources.

They facilitate the exchange of goods, making it possible to trade in a more sophisticated way rather than in simple barter. Further, trade in currency as a commodity has become common; capital supports investment and investent increases productivity.

Japan has made a number of very substantial advances in recent years as to the facilitation of exchanging goods. Its current account surplus this year is, as others have mentioned, Eximbank likely to reach as high as $90 billion. It enables Japan to employ a system of mixed credits to a degree that has never been available to the United States, to use its Eximbank in ways that our Eximbank does not facilitate trade in goods.

As to the issue of trade in currencies as a commodity, I was in Tokyo last week on the day that the Tokyo offshore banking facilities were opened amid a certain amount of hoopla which was broadcast liberally in the visual media and covered liberally in every single newspaper in Japan.

Incidentally, I was given what to me was an extraordinary revelation. The seven daily newspapers in Japan are read by an extraordinary number of people. The one that has the smallest circulation in Japan has something over two times the circulation of the

New York Times and the one with the highest circulation in Japan is read every day by over 8 million people, more than the combined circulation of every single major newspaper in the United States.

As to the use of capital as support for investment and improvement in productivity, the cost of capital in Japan has remained very low and that has greatly facilitated improvements in manufacturing efficiency as well as the ability to more rapidly respond to trading situations.

I happened to have taken issue with the United States-Japanese semiconductor agreement because I don't think it gets to the root of the problem, which is the relatively cheaper cost of capital for Japanese companies, a situation that's only going to be enhanced by the establishment of cartel pricing mechanisms, such as the semiconductor agreement.

I had the pleasure of being in Japan at the time the Maekawa Report was produced, in April 1986, and last week in Tokyo Maekawa "1.5" was issued. That is, the mid-term update, as it was described.

Mr. Chairman, it's a matter of some disappointment because the expectations for the Maekawa Report have been so great and I believe that we in the United States may be being mislead and we may unfairly be misleading our counterparts in Japan by placing so much weight on what the Maekawa Report will do.

It seems to me that however important, it is not a near-term solution to our economic difficulties with Japan, and most people recognize that.

What I wanted to call your attention to here is that when the Maekawa Report was issued last April 7, it concluded by saying, "The Group of 21 very much hopes that the government will make every effort to implement these recommendations with the full understanding and support of the entire nation."

Now Maekawa 1.5 issued December 1, 1986, has a caveat built into it that "of course the report needs further study"; that it is not meant as a document to be implemented and is really just a talking paper, as might be said in the executive branch.

So I would like to urge that no one in the Government of the United States be mesmerized by the Maekawa Report except as it is an indicator of potential change of government policy.

Earlier this morning, Mr. Chairman, I heard several references to the GATT and the hope for improvements that will be made possible in trade and services, and I believe that would incorporate the financial area; I would like to urge that neither the Congress nor the administration and certainly not the people who are the ostensible private sector beneficiaries be mesmerized by the GATT.

We are more likely to see results out of the Maekawa Report much faster than we will out of the GATT. It is a potentially nonharmful instrument and it may even be helpful if the United States is particularly skillful in the negotiating process over the 6 or 7 years.

In conclusion, Mr. Chairman, I would like to again urge that in considering "competitiveness," all parts be incorporated—trade in goods, in services, and in financial aspects of our economies as well, by the Congress, the private sector, and the administration.

I am admiring of the Young Commission Report of a little over 2 years ago which seems to have resulted in the establishment of a private sector council on competitiveness chaired by Mr. Young of Hewlett-Packard and several other chief executive officers of major corporations in the United States. I believe that Senator Chafee has undertaken to establish something like a competitiveness caucus in the Congress and I don't know much about it but hope that it too will look at these areas, and I know in the administration that Vice President Bush has been chairing an interagency group looking at the competitiveness issues as well.

I hope all three don't kill the subject of financial services, it has a chance of rising up and being competitive with Japan and others in the world that we need to be competitive with. Each of these efforts, I hope, will encompass the broader range of issues and particularly that area that you have asked us to talk about this morning, that of financial services.

Without any further comment from me, I would like to turn to Kent Calder, whose biography is available to everyone in the room, and ask if he would begin before Bob Hormats, since I'm advised that Mr. Calder is more likely to give us a historical perspective which may make it easier for us to go forward.

STATEMENT OF KENT E. CALDER, PROFESSOR, WOODROW WILSON SCHOOL OF PUBLIC AND INTERNATIONAL AFFAIRS, PRINCETON UNIVERSITY

Mr. CALDER. Thank you, Lionel. I would like to talk briefly about how it is that we came to the particular pass that we face now, with Japan as banker to the world.

As we look at the early postwar period, there is nothing more striking than the sharp historical reversal in the financial positions of Japan and the United States.

For the first 20 years of the post-war period, not once, for example, until 1964 did Japan have a real trade surplus. Upon occasion it would have windfall benefits from United States procurements in Korea and so on, but there was no underlying postwar trade surplus in Japan aside from military procurements, until 1964. Sometimes Japan was forced to go to the IMF for assistance, as in 1957, because of these basic underlying problems—raw materials, shortages, the need to import, and so on.

So this situation that we began to have in the early 1980's, of Japan becoming the world's most important creditor and capital exporter, is very, very striking.

One dynamic here, of course has been Japan's rising trade surplus—$35 billion in 1983, rising to $53 billion in 1985. This transformation has also been aided—and I will stress this later—by important regulatory changes, as well as by certain changes in savings behavior within Japan.

These capital outflows from Japan grew very sharply from virtually nothing in 1981 to well over $100 billion gross capital flows for 1986. For October of 1986 alone, Japanese capital outflows were over $16 billion. The $100 billion figure is more than the total on an annual basis—I think it's important to stress this—for all of OPEC at the height of its wealth.

Japan's net assets abroad had risen by the first part of 1986 to $130 billion, and they have risen substantially since.

By comparison, we have Britain with around $90 billion; West Germany, around $50 billion; and the United States, close to zero. This was at the beginning of the year, and our position has deteriorated dramatically since.

Japan's emerging capital surplus is sharply different from that which we saw 10 years ago in the case of OPEC. Japan is much larger, both in absolute scale and in its concentration on American financial markets.

Second, it's medicated through non-American financial intermediaries. The Arabs put their money primarily into bank deposits with Western banks, but Japanese surpluses are handled much more significantly by Japanese financial intermediaries. There are some implications for service trade here, as Lionel was perhaps suggesting.

Third, these capital flows, reiterating the point that Professor Patrick was making earlier, are likely to be much more sustained than capital flows that we have seen in the past. They have their origins in deeply rooted structural features of the Japanese political economy, many of these just emerging. This is why we didn't see the same pattern 5 or 10 years ago. Japan's capital surpluses are not dependent on the volatile fluctuations of commodity markets and the ability to maintain a cartel, which was what we had in the case of OPEC.

These capital surpluses, I would argue, are not only likely to be sustained, but they are having now and will continue to have important geostrategic effects. This is something that hasn't been stressed thus far. But these Japanese capital outflows have made economically possible the substantial U.S. buildup of the last 4 years. If we plot the two against one another we see that the increase in Japanese outflows to the world is almost precisely half of the amount of the increase in the American deficit over that time, which of course is profoundly related to the combined buildup and also the reduction in taxes that took place earlier on in the administration.

So there are geopolitical, geostrategic dimensions to these capital outflows from Japan into the United States, which I think in part help to explain some of the paradoxes that were presented in the first panel. These geopolitical dimensions help explain why the flows are occurring and nothing much is seemingly being done about them.

Also, as we look to the future not only are there the geostrategic questions, the relationship to the defense budget and so on, but there are also global questions concerning the future of the Third World, particularly the debt crisis and so on. Japan and these massive capital outflows from Japan bear very importantly on those Third World problems.

Looking very briefly at the origins of the capital outflows, we have the high savings ratio of Japan. Between 1971 and 1979, Japan's gross domestic savings averaged around 34 percent of GNP. This has declined very slightly because of some transformations within Japan to something like 32 percent in 1985. The projections that I've seen are that we will see it continue to decline slowly as a result of the increasing number of the aged in Japan. But probably not any long-run or any rapid decline in the savings ratio over the short run. These things are structurally, institutionally rooted, as has been stressed.

In the last 5 years we have also seen sharply reduced domestic investment in Japan. Gross domestic investment was down four points between 1980 and 1984. This was coupled with a declining public sector debt which fell from 7.3 percent of GNP in 1981 to 3.6 percent in 1985. So these two factors combined—the reduced investment and then second the declining public sector deficit, resulted in a shift of 7 percent of GNP—which is really a major factor behind this very sudden emergence of Japan's capital surpluses.

There have certainly been some one-time factors. For example, the glut in oil markets and other commodity markets over the last year. But I would emphasize the long-run factors. Changes in the political system also relate to this decline in Japanese Government spending.

We also have one final thing, a transformation in Japanese economic structure away from the energy-intensive industries that have given Japan these heavy raw materials imports toward computers, telecommunications, semiconductors, which are not terribly resource intensive. So there's fundamental structural change going on in the Japanese economy which underlies some of these structural surpluses that are arising.

Looking to the future, what is the prospect for this surplus? As I say, I tend to think it's quite deeply rooted. There's a psychological factor. Japan is aging rapidly. People are concerned about beginning to consume very rapidly, partly because they are concerned about the future—the problems in the welfare system and so on. There's the institutional gaps—no tax deductions on home mortgages, for example. There are problems of absorbing additional spending. For example, housing and land development. This is a very important area.

Japan has low taxes on agricultural land which limit supply of land for housing, and it's very politically difficult to dismantle these.

So, in short, few alternatives to saving exist, which propels this capital out into the international arena. Before discussing international aspects, I would stress one additional dimension that I don't believe has been talk about enough, and that's the regulatory side. We see that there have been some very important changes in Japanese regulatory policy in the last 5 years that have enabled the capital surpluses that were rising to flow out into the international economy.

There's the Japanese Foreign Exchange Control Act of December 1980, just as the Reagan administration was coming into office here. There have been important changes in the fiduciary requirements for insurance companies and so on, which limit the extent to which they are permitted to invest in foreign assets; 35 percent of assets may now be invested overseas, and that's up from 10 percent since the beginning of this year.

Then there's also a massive pool of savings, in Government financial institutions which is just beginning to flow into international financial markets. Taken together, the various Government trust funds have total assets well over $1 trillion. This represents something on the order of the quarter of the financial assets of the entire Japanese financial system. Only about 10 percent of this huge pool of savings is currently invested through capital markets, with the rest going largely to the Japan Development Bank and a wide range of other Government financial institutions.

There's been the beginnings of liberalization in that regard. Postal Life Insurance, for example, invests overseas to some extent. Probably within this very month, we will see some important developments regarding postal savings—the beginning of the liberalization on the use of assets of this massive postal savings fund. It has assets of over $600 billion, which is nearly four times the size of Citibank, and it is reportedly going to be announcing some important liberalization of its foreign investment policies.

So on the regulatory side there are forces which, if anything, are propelling, intensifying capital flows outward, together with the basic macroeconomic forces that have been stressed before.

Just very briefly, what are the implications of this for our trade in financial services? Bob, I suspect, will talk in detail about this and so I won't treat elements of securities and investment banking in any detail. But I think it's fair to say that there are going to be some very substantial increases in the global role of commercial and investment banks from Japan as a result of these capital outflows.

Seven out of eight of the largest commercial banks in the world are now Japanese; three out of four of the largest investment banks in terms of assets. As we move toward 24-hour trading, these strategic positions that these Japanese firms have in Tokyo will become more important. They are also establishing a major presence in London and in New York.

But that whole question aside of the commercial banking and securities, there are some other important areas of service trade where Japanese competitiveness is rising significantly. One of these is equipment leasing, where as a result of the Foreign Exchange Control Act of 1980 cross-border leasing became possible. We've seen Japanese trading companies and leasing companies, for example, lending very extensively to airlines for buying aircraft and then leasing these aircraft. American Airlines, for example, has been involved in several of these arrangements.

In real estate and real estate finance we've also seen the Japanese role rising quite substantially.

So the service-trade implications are a relatively pervasive phenomenon which goes far beyond investment banking and commercial banking. It does have the obverse. There are important U.S. opportunities in Tokyo that are opening up as a result of the liberalization of Japanese financial markets and Japanese capital outflows. Many of these are in underwriting and securities trading on a global basis, in relation to this integration of London, Tokyo, and New York.

In addition, there is also potential for American firms in pension fund management, relating to this transformation in the age structure in Japan and parallel concern at this point regarding how investment assets for retirement will be managed. In insurance there's also some potential. I think we might point out, for example, the case of the cancer insurance. As some of you know, nearly 1 in 10 Japanese currently hold a cancer insurance policy that's written by the Japan branch of American Family Life Insurance of Columbus, GA. It's a relatively small company. As a result of cancer insurance it has annual revenues over $350 million a year in Japan alone, which is actually the bulk of the business. That's just an indication. There are others. Insurance in potentially a two-way street as far as service trade is concerned. Although major regulatory problems remain in Japan.

In terms of the trade flows within the Basin—financial changes themselves don't necessarily intensify Japanese competitiveness in manufacturing as strongly as one might think. There's the differences in the cost of capital between the United States and Japan that Lionel mentioned. Increasingly, as the Japanese markets become liberalized it becomes possible for American firms also to go to those sources. Japanese financial institutions, especially the trading companies, have some incentives under the status quo to aid United States exports. We find, for example, that Mitsui is one of the largest exporters from the United States. Trading companies have especially strong incentives to export U.S. goods in the context of the strong yen and trade frictions.

Third, I think there are some prospects for further imports into Japan in energy-intensive raw materials. Take aluminum, for example. There's been some big shifts there. In crude steel just within this last year, Japanese crude steel imports have increased quite dramatically.

But the prospects for more imports into Japan as a solution to these imbalances is, I think, somewhat mixed. There are labor-intensive sectors close to the Liberal Democratic Party—plywood would be a good example—where I think the problems are going to be really quite intractable.

Then finally, back to the global implications of Japanese capital flows, I think that there are a range of tradeoffs between defense budget, the financing of our national budget deficit and so on, on the one hand, and the trade issues; we need to realistically weigh deterioration of our position in some of the service trade areas against the benefits we obtain from capital flows.

Looking to the future, I would certainly hope that we will see a diversification and movement from the sort of pattern that those flows have taken in the past, toward a greater flow toward the Third World. But in this respect we need new multilateral incentives. This body and the United States generally must show that we consider Japanese aid to be something important, because the range of groups which are deeply concerned about the global debt crisis within Japan is relatively limited.

Japan has about 15 percent of the total debt exposure of the major industrialized nations and that includes the largest piece of Philippine and Indonesian debt and also around 15 to 20 percent of Mexico's debt. Several of the Japanese banks are quite deeply exposed in the Third World.

But aside from the banks, you will find relatively few groups in Japan who are concerned deeply about this exposure. The securities companies, for example, which are quite powerful, are not preoccupied with the question. As Professor Thayer mentioned, much of the Japanese political world is also quite domestically oriented, and is not too concerned about these sorts of global questions.

In terms of the way in which Japanese capital flows will be recycled there are some fundamental issues—some bilateral issues certainly between ourselves and Japan, but also, multilateral questions—the creation of new facilities through the IMF or other multilateral bodies to encourage the recycling of Japanese capital outflows in different directions than we have seen in the past. Thank you.

[The complete statement of Mr. Calder follows:]

STATEMENT OF

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BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

SYMPOSIUM ON U.S.-PACIFIC RIM RELATIONS

DECEMBER 11, 1986

Market forces over the past five years have driven the Japanese and American economies toward substantially deeper and different patterns of trans-Pacific integration than they have ever before witnessed. The most substantial of those new forms of integration has been the massive flow of Japanese capital exports to the United States. From virtually nothing in 1981, Japan's gross global capital exports have risen to a likely total of $120 billion for 1986, the bulk of which is being invested in this country

These new capital flows from Japan are substantially greater than those from all the OPEC nations combined at the height of their wealth. Most of this new Japanese investment in the U.S. has been going into securities, particularly U.S. Treasury bills. But Japanese direct foreign investment in this country did also rise by over 60 percent during 1985, and is rising faster still in 1986, as the effect of sharp currency realignments since September, 1985 is increasingly felt.

The United States has, of course, experienced major capital inflows before, which have also contributed to domestic economic vitality. Sustained inflows during the pre-World War II and wartime turbulence in Europe both stimulated the American economy and provided the strong financial asset position which underlay this nation's key role in the Bretton Woods international financial system of the post-World War II period. Capital inflows from OPEC nations after the two Oil Shocks of the 1970s helped offset the deflationary effects of large oil-price increases, and thus helped to keep the American and other economies on an even keel.

The current capital inflows from Japan, while similar in their stimulative economic effects to patterns of the 1970s, contrast to the OPEC-related capital flows in three major ways. They are even larger in scale, both in absolute magnitude and in their concentration on the American financial market. The crisis of Third World debt discourages the broad global recycling which occurred after Oil Shocks I and II. Secondly, the current capital inflows to the United States are occurring much more heavily through non-American financial intermediaries than was true ten or fifteen years ago. OPEC surpluses of the 1970s went largely into bank deposits at major Western commercial banks, and were recycled to the rest of the world through those banks. Japanese surpluses, by contrast, are being handled primarily by Japanese financial institutions, which loom larger and larger on the global scene. Thirdly, current Japanese capital outflows appear likely to be much more sustained than those of OPEC in the 1970s, since they have their origins in deeply rooted structural and cultural features of the Japanese political economy, rather than in the volatile fluctuations of international commodity markets.

Recent projections by the Nomura Research Institute suggest that Japan's external assets in 1995 could well reach $1 trillion. Even if this massive scale is not attained, fundamental structural features of economies in the U.S., Japan, and the developing world suggest both that large Japanese capital exports will continue, and that the U.S. will remain by far the largest debtor as Japan expands its foreign asset base. Current capital flows from Japan to the United States, in short, have major implications for the U.S. economy, for the global financial services industry, and for the broader American role in world affairs.

In their aggregate these implications are potentially more far-reaching than those of any single international economic development which this nation has faced since the foundation of the Bretton Woods system at the end of World War II. Yet both the capital flows themselves and their prospective consequences remain remarkably unexplored.

THE FUTURE OF JAPANESE CAPITAL FLOWS

Capital flows between Japan and the United States are in their essence driven, of course, by underlying patterns of supply and demand in the two nations for funds, operating within the context of an increasingly integrated global financial market. The domestic factors in this equation, such as the scale of our national budget deficit, levels of domestic savings, foreign investment incentives, and the vigor of private investment demand in this country, are often discussed. But it is crucial to remember that these alone do not determine the flow of Japanese funds to this country. Also crucially important is the less fully appreciated Japanese side of the equation.

The central institutions of the Japanese political economy, which underly that nation's biases on savings and investment, were forged during the turbulence, insecurity, and want of the 1930s and 1940s. They have a natural bias toward encouraging savings, discouraging consumer extravagance, and channelling the proceeds toward industrial investment -- toward solving, in short, the fundamental problems of industrial competitiveness in the uncertain and largely hostile global political economy which faced Japan at that time. To be sure, market forces have significantly transformed the Japanese financial system since 1970. But there was little institutional or political impetus, in the financial and administrative structure as liberalization began, toward consumption-oriented reforms. Even today, Japanese cannot deduct home mortgage interest from their income taxes or receive extended credit for credit card purchases. And there is little movement for introduction of such reforms, which lie at the heart of American consumer finance.

Deep-rooted psychological factors also underlie the savings-oriented status quo. Japan is currently on the verge of one of the most rapid increases in aged population which any advanced society has ever undergone. This is happening in a nation without a strong tradition of public welfare, which is currently undergoing substantial welfare-entitlement cutbacks. Not surprisingly, the elderly and middle-aged in such a society are reluctant to increase consumption and decrease savings regardless of what Prime Minister Yasuhiro Nakasone or Western commentators may advise.

For a combination of institutional and cultural-psychological reasons, Japanese savings rates have thus persisted at extremely high levels, despite Japan's rising affluence. Gross domestic savings for the 1971-1979 period averaged 34.2 percent of GNP; this share had only declined by 2 points, to 32.1 percent, by 1985, largely to demographic changes. Recent studies suggest a likely gross domestic savings ratio of around 30 percent, or perhaps even more, in 1990, despite a continued rapid increase in the over-65 share of the Japanese population. Although future projections on such matters are of necessity speculative, savings rates in Japan seem likely to continue sharply higher than in the United States and the major Western industrial nations. And straightforward pressures for individual Japanese to consume more, however rational in purely economic terms, appear likely only likely to stir resentment in Japan, given the prevailing social context and value structure there.

As long as Japan's large pool of savings could be absorbed domestically, there were, of course, few strong economic pressures toward capital exports. But after 1980 this situation began to change rapidly. Between 1980 and 1984, gross domestic investment as a share of GNP declined by four percent, as stagnant export demand everywhere but in the United States and China led to sagging private-sector investment within Japan. At the same time, Japan's public-sector deficit was cut in half, from 7.3 percent of GNP in 1981 to 3.6 percent in 1985, under the pressure of administrative reform. This trend toward fiscal retrenchment was greatly aided by declining pluralism in the Japanese domestic political world, which reduced pressure on the government for expansionary social programs.

The prognosis appears good for moderately expansionary Japanese government policies, particularly given the likely retirement of Prime Minister Yasuhiro Nakasone, strongly committed to administrative reform and fiscal stringency, during 1987. But the scale of stimulation in prospect comes nowhere near the 7 percent of GNP by which two major components of domestic demand (domestic investment and national government spending) have in aggregate declined since 1980. Political rivalries both within the ruling Liberal Democratic Party and between the LDP and its opposition often intensified the expansionary bias of Japanese fiscal policy during the 1960s and 1970s. But these rivalries now seem much less likely to exert pressure for expanded spending than formerly, especially in the wake of the LDP's massive election victory in July, 1986.

As private capital investment and government spending decline, the prospect for expanded spending on real-estate and housing development become the most important prospective source of domestic demand expansion within Japan. Some large projects, such as the Tokyo Bay Bridge and the New Osaka International Airport, are proceeding ahead at an accelerated pace. But the prospects of a massive nation-wide land development boom which would transform the fundamental thrust of demand stimulation in Japan are relatively remote. The major problem is Japan's system of very light taxation on land in urban areas used for agricultural purposes. This keeps land prices high, reduces urban population densities, and discourages rapid conversion of farm land to housing. This agricultural land taxation system is deeply rooted in the structure of political power in Japan, and will be politically difficult to change.

LIBERALIZATION OF JAPANESE CAPITAL OUTFLOWS

The prospects for continued high domestic savings and low consumption within Japan appear strong, on the part of both the public and the private sector, despite the likelihood of some marginal change. As a result, economic pressures within Japan for large-scale capital outflows seem likely, unless another major commodity-price increase like the Oil Shocks of 1973 and 1979-1980 should occur. But the scale on which those capital exports occur, and the form which they take, is profoundly affected by the regulatory context within Japan, as well as by market forces. For significant regulatory controls over Japanese capital outflows remain, although they are being steadily removed. Enactment of the landmark Foreign Exchange Control Law of December, 1980 essentially liberalized all cross-border financial transactions unless specifically prohibited or constrained; since then, crucial legislative and especially administrative decisions have cleared the way for a much broader range of financial and non-financial actors to invest larger amounts in capital markets outside Japan than had been previously the case.

These regulatory changes have had major impacts on both the volume of funds and the sort of funds which are flowing out from Japan. These changes also influence profoundly the range of investment options to which Japanese capital can realistically be employed. They also shape the opportunities and challenges which Japanese capital outflows present to American financial intermediaries.

The 1980 Foreign Exchange Control Law essentially liberalized all cross-border financial transactions unless specifically prohibited or constrained by Japanese financial authorities. Among its most immediate effects was to make cross-border equipment leases possible. Since that time, Japanese leasing firms have acquired airliners and industrial plant facilities abroad and then disposed of them in increasing volume to foreign corporations or governments, including in several instances U.S. airline companies such as American Airlines. These so-called "shogun" cross-border leases totalled $4.5 billion between 1981 and 1984, and have continued to increase. The relatively low interest rates on long-term yen funds have played an important role in Japanese leases to overseas lessees. Many of these leases have been handled by Japanese general trading companies, which combine trading and financial functions in their normal range of activities, although Japan also has developed rapidly growing specialized leasing firms. Since the leasing sector in Japan is supervised by the Ministry of International Trade and Industry rather than the Ministry of Finance, this sector has faced few constraints on its overseas financial activities since passage of the new Foreign Exchange Control Law.

Relaxation of foreign exchange controls in 1980 also had a substantial impact on international securities trading by Japanese firms. By the end of 1985, international bond purchases from Japan came to $291 billion, and sales to $238 billion, up from minuscule volumes in 1980, with the bulk of these transactions being handled by Japanese institutions. International equity trading by Japanese firms has developed much more slowly, but has begun to surge rapidly since the beginning of 1986.

Foreign-exchange trading in Japan was given substantial new impetus, beyond that supplied by 1980 legislation, in April, 1984, when the so-called "real demand" rule was relaxed. This had required proof of a merchant or capital transaction behind forex transactions by corporate non-bank entities. The principal immediate effect was to enhance the role of general trading companies in international financial dealings, although since 1985 the trading companies have also been actively joined by manufacturers as well. Cash-rich firms such as Toyota Motors, with over $9 billion in liquid assets, and Matsushita Electric, with over $7 billion, have generated huge pools of liquid assets, from a combination of export profits and declining capital investment prospects. They find it increasingly attractive to think of seriously managing some portion of their assets independently of the financial world, on a global basis.

Fiduciary requirements imposed upon insurance companies continue to constrain capital outflows from Japan, although there has been substantial loosening of existing restrictions since 1980 which have made these firms major actors in international financial markets. Insurance firms may hold no more than 35 percent of their assets in foreign-currency denominated assets, although this ratio has been increased from 10 percent within the past year, partially in an effort to moderate the pace of yen revaluation. Currently foreign assets account for about 18 percent of the total assets of ¥53.9 trillion (around $337 billion at current exchange rates) held by the insurance companies, so this ceiling is less constraining than it was in previous years.

Japan's semi-public small-business and agricultural finance institutions, the Nōrin Chukin Bank and the Shōkō Chukin Bank, are also major new actors on the international financial scene. Throughout the 1970s these funds-surplus institutions were major purchasers of Japanese government bonds, often at below-market interest rates. But with liberalization of restrictions on international financial transactions, they have been investing ever more heavily abroad, due to higher returns than those available in Japan.

Restriction on foreign securities purchases by the postal life insurance and annuities fund (with assets of ¥30 trillion, or over $180 billion) were a major barrier to capital outflows during the early 1980s. But these were relaxed by the Ministry of Posts and Telecommunications (MPT), which administers the fund. At present 23 percent of total assets entrusted to this fund are invested at its own discretion, in accordance with market dynamics. This fund is one of the major new prospective Japanese financial investors on the international scene, and has developed relationships with major American financial institutions such as Merrill Lynch and Salomon Brothers.

The national pension system is another large pool of government funds whose investment is steadily being liberalized. Currently 10-12 percent of the ¥60 trillion ($375 billion) of assets in this fund are freely deployed by the pension system, with the rest being lent largely to the government financial institutions. These funds are managed by trust banks and insurance companies, and are the administrative responsibility of the Ministry of Health and Welfare.

By far the largest financial institution in Japan is the postal savings fund, with total assets of ¥100 trillion (over $600 billion). This huge institution, with 3.6 times the assets of Citibank, derives its funds from postal savings deposits, and either places them on deposit with the government financial institutions such as the Japan Development Bank or invests them in Japanese government bonds. Up to the present this postal savings fund, administered by the Ministry of Posts and Telecommunications in consultation with the Ministry of Finance, has not invested any funds abroad; indeed, it has represented by far the largest pool of capital in Japan still constrained from foreign investment.

Although the postal savings fund is at present still constrained from foreign investment, powerful economic and political pressures are currently building up in Japan which make capital outflows from this huge entity a strong possibility in the near future. Legislation during the early 1950s set a floor on the rate at which the postal savings fund may lend to the government financial institutions, which in turn constrains the rate at which they may economically lend without a government subsidy. With the sharp fall in market interest rates in Japan over the past year, it is now increasingly difficult for these institutions to find customers, given existing constraints.

Under recently announced tax-reform proposals, the Nakasone Administration in Japan is seeking abolition of tax-free postal savings accounts. When such a change occurs, it will generate strong political pressures on the postal savings fund for an increase in deposit rates. This will occur just as the demand from the government financial institutions for lower lending rates intensifies, thus threatening the viability of the system as presently constituted. The portion of total postal savings fund assets under discretionary management of the fund would reportedly be ¥ trillion in 1987, rising gradually to ¥13 trillion (almost half of annual disbursals) by 1992. The balance would continue to flow largely to government financial institutions. Discretionary management could ultimately mean a major expansion of Japanese capital outflows beyond current levels, should returns on foreign investments remain measurably higher than those available in Japan.

Taken together, the various government trust funds, discussed above, together with some smaller counterparts, have total assets around ¥200 trillion ($1.25 trillion). The represents roughly a quarter of the total assets of the Japanese financial system. Currently only around 10 percent of this huge pool of funds is invested through capital markets, with the remainder going to the Fiscal Investment and Loans Program supporting the government financial institutions. As this ratio increases, it should create a major new source of demand for foreign financial assets.

Apart from insurance, and various government trusts funds, whose large pools of investment capital have been largely insulated from international financial transactions by fiduciary requirements, there are also a large group of highly liquid potential investors in Japan who are constrained not by legislation or administrative guidance by the bureaucracy, but mostly by lack of knowledge or alternate investment opportunities within Japan itself. Most important in this regard are the regional and mutual savings banks. These funds-surplus institutions, with assets around ¥100 trillion ($625 billion) in the aggregate, have traditionally lent into Japan's highly volatile short-term money markets, such as the call market.

As excess liquidity has intensified within Japan, particularly since late 1985, interest rates on the traditional domestic investments of these smaller banks have fallen sharply. They also face the prospect of significantly narrowing spreads due to gradual liberalization of controls on savings deposits of less than Y100 million, which comprise the bulk of their deposits, in and after April, 1987. It is hence likely that they too will be thinking increasingly about international investment. This may be particularly true as the Tokyo offshore financial market, inaugurated on December 1, 1986, becomes more strongly institutionalized, and as restrictions upon its activities begin to erode.

IMPLICATIONS OF JAPANESE CAPITAL EXPORTS FOR TRADE IN FINANCIAL SERVICES

The interaction of market forces and regulatory changes within Japan over the past five years has thus had two major consequences which despite their dramatic implications for the U.S. economy and its financial markets are still poorly understood in this country. First of all, they have sharply increased the pool of Japanese funds upon which the United States may readily draw in funding its budget deficit and other investments. Deregulation, tax reductions, and other market-oriented incentives may well have helped envigorate the U.S. economy over the past five years. But they were crucially assisted by this rapidly expanding pool of accessible Japanese capital, whose scale in dollar terms has been sharply magnified by the recent yen revaluation. A second consequence of recent financial developments within Japan has been the emergence on the international scene of a wide range of new Japanese financial actors.

Most of these new actors have little experience in either international or deregulated financial markets, and tend to be quite conservative in their investment and other business behavior. A smaller number, principally the large securities companies, commercial banks, general trading companies, and leasing firms, are more innovative and strategic in their orientation. But even they are often still quite inexperienced in comparison with major U.S. and European firms, and more limited in their network of global contacts.

Equipment leasing is one service-trade sector where the impact of Japanese capital flows may be significant. The nature of the industry, involving both procurement of manufactured goods and provision of financial services, plays to traditional strengths of Japanese business practice, including the general trading company and the industrial-group, or keiretsu, structure. These features of Japanese business practice facilitate the sourcing of even complex equipment systems on efficient and relatively economical terms, which are further improved by the availability of plentiful, low-cost capital. The equipment leased in often Japanese made, parallel procedures can also be employed to lease foreign, including U.S.-made, equipment. Japanese leasing firms, for example, have dealt extensively in Boeing aircraft, thus both helping stimulate U.S. exports to Japan and aiding the emergence of a new Japanese service industry.

Real-estate services is another sector where the implications of Japan's rapidly growing capital exports may be substantial. Japanese insurance companies and real-estate interests have recently moved heavily into commercial real-estate investments, with purchase of the Arco Tower in Los Angeles, the headquarters building of ABC News in New York City, and so on. Managing these new properties could well give rise to a new service sector in the United States with substantial Japanese participation. Several of the larger Japanese construction companies are also reportedly considering expanded development activities in the United States, supported by strong access to domestic Japanese capital.

Implications of Japanese capital exports for competitive patterns in mainstream financial services sectors appears to be a much more complex proposition. Many of the newly emerging Japanese capital exporters, as noted above, are relatively inexperienced in international financial management, and lack the global networks and sophisticated analytical techniques to make them strongly competitive with major Western firms. The objectives of Japanese insurance companies, local banks, and agricultural financial institutions on the international scene in any event appear to be quite passive and conservative.

There is little doubt that the major Japanese securities firms and commercial banks have a promising future at the core of global finance, particularly with the emergence of twenty-four hours trading, and the growing integration of major global markets. Recent revaluation of the yen has led to reorderings in relative scale which may not fully reflect actual competitive capabilities. But it is striking to note that at current exchange rates three of the four largest investment banks in the world, measured in terms of equity, and seven of the eight largest commercial banks in the world, measured in terms of assets, are now Japanese. In the three key centers in the emerging trilateral world of global finance, Japanese firms have a dominant position in Tokyo, together with a 23 percent share of all banking assets in Britain, and an increasingly vigorous role in New York.

Japanese financial intermediaries have strong, although somewhat varied, incentives for going international. The most general incentive is declining rates of return within Japan, flowing from a profit squeeze due to intensifying competition and interest-rate deregulation there. Roughly two thirds of the new funds in commercial banks, for example, now come from instruments with market-determined interest rates, as contrasted to less than one-third only five years ago. Liberalization has reportedly already cost commercial banks as much as ten percent of their net income in the form of higher interest payments to depositors. General trading companies also suffer from declining margins in traditional businesses, as Japan's trade structure shifts from raw materials and other commodities to higher value-added products where the trading companies' volume-oriented expertise does not apply so effectively. It is such changes in existing markets which forces the trading companies aggressively into new service businesses such as leasing and foreign-exchange trading.

Confining regulatory structures at home are also motivating Japanese firms to venture abroad. Banks, for example, are kept out of securities business at home other than government bonds and debentures by Article 65 of the Japanese Securities and Exchange Act. But they face fewer such barriers overseas, particularly in the Euro-markets where most of them have securities subsidiaries. Although the so-called "three bureau agreement" prevents banks from acting as lead managers or book-runners outside Japan, they can lead manage Japanese-government guaranteed issues or foreign issues overseas.

Japanese banks and securities firms have, to be sure, some decided strengths in international markets, particularly their enormous placing power within Japan. This placing power, based on strong retail networks in Japan, has expanded sharply in the past year, together with the steady revaluation of the yen. It no doubt helps Japanese firms, especially those in underwriting, to attract non-Japanese customers outside Japan.

Japan's relationship to the international debt crisis may have some impact on the relative competitive position of Japanese as compared to U.S. financial institutions. Banks in Japan, to be sure, hold 10-15 percent of all third-world debt, including the biggest portion of Philippine debt , a quarter of Indonesia's, and 15 percent of Mexico's. But U.S. banks are even more heavily committed. As a result, they may need to increase spreads more extensively or to make more elaborate provisions for losses than Japanese banks, to compensate for this added debt exposure.

Yet internationalization may also have some impact on Japanese competitiveness in international finance. Due to their weak yen deposit bases American banks confront a somewhat higher cost of funds for yen-based transactions than do their Japanese counterparts. This situation will be somewhat alleviated, however, as new financial instruments develop in the Tokyo money market.

Japanese financial intermediaries also have some specialized regional expertise which gives them leverage, particularly with customers interested in doing business with China. China sold its first post-1949 foreign bonds in Tokyo, and at least four major Japanese banks have shares in joint leasing and investment banking organizations in China. For American firms interested in expanded trade financial and broader business dealings with China, the experience and contacts of Japanese banks and securities firms can be a distinct advantage.

American banks and securities firms, of course, have distinct strengths of their own which counter-balance those of their Japanese counterparts in many areas. As in high technology, global contacts, extensive branch networks, and considerably longer experience than Japanese firms in working with volatile, deregulated markets provide American firms with important comparative advantages. In innovative, rapidly changing market segments, such as interest-rate swaps, securitization, and global electronic funds management American firms appear to be particularly strong. The competitive dangers for them, as in high technology, seem to lie in the standardized, commodity-oriented sectors. But these are not the most rapidly growing or most profitable segments at present of international finance.

Together with competitive opportunities for Japanese securities firms and commercial banks in major global markets, Japan's recent moves toward financial liberalization and capital exports also provide opportunities for U.S. firms in Japanese markets which cannot be ignored. Some of the strongest prospects could be in pension-fund management. Japan's total pension assets are expected to grow by more than 50 percent (to around $140 billion) by 1990, and American firms have extensive expertise in pension fund management. Nine foreign firms have recently been licensed to set up such operations as foreign-owned Japanese trust banks. Foreign commercial banks in Japan also have a relatively strong position in the Japanese consumer finance market, while investment bankers and securities firms are cultivating the rapidly growing community of prospective Japanese investors in U.S. securities. Should exchange-rate and interest-rate profiles make dollar-denominated assets attractive, the role of these American firms in the Japanese market could gradually continue to grow.

IMPLICATIONS FOR TRADE FLOWS WITHIN THE PACIFIC BASIN

The increasing scale and power of Japanese financial institutions may, when seen within the larger context of trans-Pacific trade tensions, have surprisingly positive implications for U.S. exports. Japanese trading companies, such as Mitsui and Company, already number among the largest exporters of American products, and rising trade tensions should give them even stronger incentives to increase exports from the U.S. Easiest and most profitable for Japanese firms to undertake would be comprehensive development projects, which involve supply of equipment and capital, as well as product marketing.

Japanese trading firms have also been active recently at generating third-country trade flows in the Pacific which do not touch Japanese shores at all. The general trader Nissho Iwai, for example, was reportedly instrumental in aiding Nike, the sports-shoe manufacturer, to national prominence in the U.S. by helping organize off-shore production facilities in South Korea, while also handling export of the finished product to the U.S. Marubeni Corporation, among others, has also reportedly been instrumental in facilitating two-way trade between Indonesia and the United States.

Japanese general trading companies may well, especially in the context of current trade frictions, have incentives to organize and finance U.S. exports to Japan of high-technology products and commodity goods, particularly of unfinished raw materials. But it is important to differentiate between relatively open sectors of the Japanese market, such as raw materials and high-margin, low-volume margin consumer goods, and those which are more difficult for foreign firms to penetrate. Particularly difficult to penetrate will be the labor-intensive, low-growth, raw-materials processing sectors such as the plywood market. In these sectors imports pose a substantial prospect of unemployment in Japan, as well as conflicts of interest for the trading companies, who both supply raw materials to small produces firms and also market the finished products of those firms.

Labor-intensive products are not, of course, prospectively a major element in U.S.-Japan trade in the years to come, so the relatively closed nature of the Japanese market with respect to some such products may pose no more than a minor irritant to U.S.-Japan bilateral relations. Agricultural issues, appear both more important economically and more tractable politically, due to ongoing political and economic changes within Japan. Japanese barriers in labor-intensive manufactures could pose a more significant obstacle to the expansion of developing-nation manufactured exports, and hence to region-wide adjustment within East Asia.

But problems in labor-intensive sectors are partially offset, however, by encouraging patterns in more capital-intensive sectors. Japanese firms have completed a $2 billion aluminum smelting complex in Indonesia, the Asahan project, which now supplies a major share of the aluminum ingots consumed in Japan. Under the impact of the strong yen, Japan also appears to be increasing steel imports, with recent reports indicating a crude steel import ratio of ten percent -- more than half that of the United States.

GLOBAL IMPLICATIONS OF JAPANESE CAPITAL OUTFLOWS

Since the early 1980s Japanese capital outflows have become crucial to the U.S. Government in financing our national debt. In 1985 Japanese investors' net purchases of Treasury notes and bonds totalled $19.2 billion. This represented two-thirds of all foreign purchases of Treasury debt last year, and 12.8 percent of net new Treasury financing. The role of Japanese investments has been even more significant in 1986, especially in longer-maturity issues.

Both Japan's direct purchases of Federal debt and indirect support through purchase of other U.S. financial instruments have made it politically possible for the Reagan Administration to finance huge budget deficits without a credit crunch which might force politically disastrous tradeoffs between public and private spending. The U.S. federal budget deficit increased by $133 billion between 1981 and 1985, while Japanese capital outflows rose almost precisely half that amount. Japanese capital outflows have thus crucially financed American global commitments, including a sustained military buildup at a point where economic weakness would otherwise have forced cutbacks or politically delicate tax increases. These capital flows have, in a word underwritten U.S. global hegemony. They have made Japan in a sense America's preeminent strategic partner, despite its low military spending.

Japanese capital outflows also prospectively bear a major relationship to resolution of the global debt crisis. The bulk of what are now the international banking community's problem loans to developing countries had been made by the time Japanese banks became major lenders. The largest debtor nations, such as Brazil, Argentina, and Mexico, are countries whose traditional economic and security relationships are preeminently with the United States. But Japanese banks have substantial self interest in viable international schemes for dealing with the international debt problem. As noted above, they hold 10 to 15 percent of all third world debt, with two-thirds of their exposure in Latin America. They are also the largest lenders to the two major Southeast Asian nations with greatest debt-service problems, the Philippines and Indonesia.

Although the major Japanese banks have a self-interested concern about third-world debt which parallels that of their American counterparts, this concern is much less broadly shared in Japan as a whole than in the United States. The major securities firms, increasingly powerful within the domestic Japanese political system, are not deeply preoccupied with the problem. Neither are most Japanese manufacturing interests within Japan, which traditionally do much less exporting to the major debtor nations, such as Brazil, Argentina, Mexico, or even the Philippines, than do their counterparts in the United States.

Ultimately Japan's most compelling interest in third-world debt questions flows from its relationship to the United States, and its related interest in the overall stability of the international trade and monetary system created and sustained largely by the United States. Japanese policymakers are generally reactive on major questions of foreign economic policy, and nowhere more so than on global debt. Japan has the financial resources to make a major contribution to resolution of third-world debt issues, but it lacks the incentives or the internal decisionmaking structures to take the initiative. That must come from the United States.

Many economists stress manufactured exports from developing nations to the developed world as a major element of third-world debt resolution. In 1985 the U.S. took 63 percent of LDC exports of manufactures to the developed world, while Japan took only 7.5 percent. Clearly Japan needs to take many more third-world manufactured exports, or make commensurate alternate contributions to the global adjustment process.

Japan should clearly be encouraged to take more manufactured imports from third-world nations. But it is important to remember how the Japanese political system shapes the relative costs and benefits of various proposals to Japan. Japan will have relatively little difficulty absorbing more energy-intensive, low-value added manufactures, such as crude steel and aluminum ingots. Taking in more agricultural imports, especially beneficial to Japn from an economic viewpoint due to its factor endowment, should also become increasingly possible. Absorbing more labor-intensive manufactures such as plywood will be harder. The U.S. political capital expended in pressing it to do so will be high, due to traits of the Japanese domestic political system.

The most favorable political cost-benefit ratios for the United States on third-world issues lie in pressing Japan selectively, but consistently and unceasingly, for expanded concessionary aid and lending to the developing world. The Japanese Export -Import Bank has recently announced a special $1 billion credit to Mexico for financing exports to

Japan. This program should be broadened and expanded, moving beyond the financing of Japanese oil-stockpile buildups on which it currently seems to focus. Such loans should also be extended on an untied basis, for financing LDC exports to nations other than Japan.

Whatever the short-run feasibility of the magnitudes involved, the concept behind James Robinson's "Global Security Initiative," proposing a Japanese capital transfer to the developing world equal to the difference between Japan's spending on defense and foreign aid combined, and that of the United States, should be encouraged. One major element in this regard could be a central role for Japan, as principal funder behind a Global Investment Guarantee Agency, as suggested in the Baker Plan. Japan should also sharply expand its support for concessionary loans at the World Bank.

1986 may well prove to be a year of unusually high Japanese capital outflows, with J-curve effects and oil-price reductions exerting unusual one-time influences. Some projections suggest that these outflows may well decline from $120 billion to "only" $100 billion next year. But whatever the marginal decline, they will remain substantial. They could be stimulated by further Japanese financial liberalization. And cumulative effects, including a substantial debt service burden for the United States, will begin to appear. The short-run stimulus of sharply expanding capital inflows we have already seen, however, intermingled with and camouflaged by domestic influences it may have been. But the longer-run consequences are just beginning to unfold. They are the related costs and benefits of interdependence.

Mr. OLMER. Thank you very much, Kent. That was I think very enlightening and it was a little less of a historical perspective than I imagined but it was a lot more than I expected in terms of its questions about the existing power of Japan's capital surplus and the difficulties of outsiders stepping in and trying to tell Japan what to do with it.

Someone who has spent a number of years trying to tell Japan what to do with various aspects of its policymaking and surpluses is Bob Hormats, now looking at this issue from a different side and perhaps he can shed some light on just ways in which Japan can spend more, perhaps save less, and ways in which it can make better use of the current account surplus that Kent has pointed out to us.

STATEMENT OF ROBERT D. HORMATS, VICE PRESIDENT, GOLDMAN SACHS & CO.

Mr. HORMATS. Thanks, Lionel. I would just like to go through very briefy the nature and scope of Japanese financial power today because I think it's a phenomenon that most Americans really have not quite come to grips with.

First, it's useful to take a look at why Japan has accomplished this enormous transformation from a country which used to import a lot of capital to one which is now by far the dominant exporter of capital.

One key point is the enormous household savings rate of Japan, which is four times greater than that of the United States, twice that of Germany and the United Kingdom, and substantially higher than that of most other countries in the region.

Reasons for this are several. One, a social security system that provides relatively few benefits, certainly few compared to its U.S. counterpart, which increases domestic incentives to save; smaller homes and thus less room for consumption; the difficulty and expense of obtaining mortgages, thereby requiring people to save more if they want to buy houses; a whole system in the Tax Code that does not permit interest expenses to be deducted, thereby discouraging borrowing and increasing savings if you want to buy certain high ticket items—a whole array of social and structural and institutional phenomena within Japan have really led to an enormously high household savings rate.

Second, obviously, is the very large U.S. trade and the Japanese trade surplus which goes hand-in-hand with a very large savings rate. I think the two have to be looked at really as part of the same thing.

The Japanese savings rate, which is high compared to the amount of money it spends on investment and consumption, enables the Japanese to lend abroad, which in effect finances the ability of other countries to buy Japanese goods. That is to say, it finances the trade and the current account deficits of a number of other countries, including the United States.

Now parenthetically I make the point that a lot of people would argue we ought to discourage Japanese savings or encourage the Japanese to spend more at home. Well, all well and good and probably right, but let's be careful about one point. And that point is that we, as a country which consumes and invests far more than we save, need to import savings from someone, and if we don't, interest rates are going to go up. So at the same time that we lecture the Japanese on closing the gap between savings and investment, we also have to have a parallel lecture in the United States to policymakers here which is that we've got to cut the gap between our own investment rate and our own savings rate because if the Japanese and others export less capital while our capital demands remain very high, then we are going to find that the cost will be higher interest rates in the United States.

So unless we can get off this addiction to importing capital for our own consumption and investment needs, investments both in terms of Government deficits which are a type of peculiar investment, and private investment, then we're going to need this capital for some time to come.

Well, the Japanese outflow of capital has in effect enormously strengthened the Japanese securities industry and that's an industry that a number of us have paid a lot of attention to in these hearings and appropriately so. The Japanese securities industry and financial industry have really come a long way over the last few years. It is now very internationalized. There are Japanese bankers and investment bankers in New York, all over London and elsewhere, and they are doing very competitive business.

Now why can they do this? One reason is they have a vast domestic base of buyers of securities and depositors in banks. Banks have more money. Banks can make more loans and banks can make the loans at very competitive rates. The same with the securities industry. A securities industry really thrives on its ability to what we call place paper, which is to say sell bonds, notes, stocks, and other types of securities.

If you have an enormous domestic savings base, as the Japanese do, you can sell those securities a lot more easily and, therefore, you can compete very aggressively in your bids to be underwriters of large bond or large stock issues. So with the enormous ability of Japanese securities companies in their own market to sell these securities, the Japanese can bid very competitively and get an enormous amount of business from American banks and from American investment banks.

Well, it's not sufficient, of course, to sit here and say that the Japanese are very competitive. I think what is important is for the financial community to recognize this and to recognize that it too is going to have to compete very actively so that it doesn't go the way of some of the more traditional industries in this country that have failed to compete.

Let's look for a moment at who the exporters of capital are in Japan because I think this is very important. People talk about Japan as the exporter of capital. Well, there are a lot of entities in Japan which really do the exporting of capital.

Let me just give you, as of early 1986, some of the figures to illustrate the point. Japanese life insurance companies in early 1986 held $23 billion worth of foreign securities. Other insurance companies held $5 billion. Trust funds, trust banks, $25 billion; investment trusts, $12 billion; the Japanese Post Office, $5 billion. They make a surplus as compared to ours.

Much of the rest is accounted for by banks through direct loans, trade loans, interbank loans, direct investment and such things.

Now where does the money go? A lot of the money goes into fixed income securities. That is to say, bonds as opposed to stocks. And just to give you some numbers that indicate the order of magnitude—these are last year's figures because we don't have the new ones for this year. Japanese institutions last year purchased $19 billion in Treasury notes and bonds. That is to say, medium- and long-term securities, a lot more in short-term securities. That came to 64 percent of the Treasury notes and bonds purchased by all foreigners, but considerably less—only 13 percent—of net new Treasury financing in notes and bonds; and accounted for 23 percent of Japanese long-term capital outflows.

Now this has given rise to the notion that the U.S. Treasury depends on Japanese financing. That is not at the moment—I stress at the moment—precisely true because this year the Treasury in the first half of this year, so far as we are able to determine, the Japanese purchased only $2 billion of Treasury notes and bonds. That is to say again, medium- and long-term financial obligations. They certainly did, however, purchase a lot more corporate securities.

What it means is that we don't at any given point require Japanese financing in real terms, but psychologically—and this is very important—psychologically, were the Japanese to hold off participating in Treasury bond auctions it would surely raise the interest rate on Treasury securities, particularly long bonds quite substantially. And here's an important point over the medium term and that is, the more the United States depends on imported capital, the more it has to take care as to what its image is in the Japanese financial market. That is to say, if people perceive in Japan that the inflation rate in the United States is going to go up, they may well say, "Well long bonds are going to go down in value," and hold off participating in Federal bond auctions which will tend, therefore, to push up interest rates.

By the same token, if the Japanese investor thinks that the dollar is going to go down further, he will hold off for a time and wait until he can get those dollar securities at a lower dollar exchange rate. That, too, will have the effect of raising interest rates in the United States.

So a country that goes around the world, as we are, looking for capital has to take care that it satisfies the concerns of the holders of capital and those are emphatically Japanese.

Now this is a particularly important thing over the long run and I think it's why the Baker-Miyazawa thing took place. It's no accident that that largest refunding in Treasury history a couple months ago was done 3 days after the Baker-Miyazawa agreement. That is to say, Secretary Baker in his wisdom, understood that if the Japanese investors thought the dollar was going to go further down, they would hold off participating in the long-bond auction, interest rates would go up, not coincidentally a few days before the election, and Baker, therefore, thought it prudent to try to reach an agreement with Mr. Miyazawa to stabilize exchange rates, and that agreement at least temporarily did that.

But what it means is that every time—every time—we have a big Treasury refunding we've got to be very careful to stabilize the exchange rate expectations during that period lest people hold off the U.S. bond market.

Now this is not to say that the only place the Japanese can put their money is in Treasury long-term bonds or medium-term notes. There are a number of other things the Japanese could do with their money and I want to talk about these very briefly. I will not dwell on it.

First it's important to note that the holders of this money are largely private institutions. The Government has some of the money but not a lot. It's the private holders that are important here. Therefore, the Government can't simply tell them what to do. It has to create certain incentives, but that can be done.

Let's look at where the Japanese investment is around the world just to give you an example. Of the local subsidiaries—and this is how it's measured by the Japanese so I use these figures—of the local subsidiaries of Japanese companies—and the total of those all around the world is about 3,900—1,500 of those subs of Japanese firms are located in Asia, including 820 in ASEAN. Another roughly 120 are in the United States; 587 are in Europe and about 500 in all of Latin America. So the Japanese investment has been largely concentrated in East Asia and second in the United States.

There is room I think for more Japanese investment in other parts of the world, particularly Latin America. Now we can't expect the Japanese to go in Latin America and invest in poor projects in countries that have poor economic policies. But where there are sound borrowers and where there are good policies, and there are some in Latin America, the Japanese through, for instance, guarantees by their Export-Import Bank can support sales of capital equipment, spare parts and such things from Japan but also from Europe and from the United States.

This does two things. It helps these countries in debt to overcome some of the debt constraints and it helps to boost exports from a variety of countries, thereby participating in the international adjustment process. And the Japanese can help their individual investors, direct investors, perhaps through the use of temporary tax incentives to invest in Latin America and other high debt countries around the world.

So there are a number of techniques that the Japanese Government can utilize not to tell companies what to do but to provide the right sort of incentives for the Japanese companies to take actions which are of a long-term structural benefit to other parts of the world, particularly Latin America.

Now I think it's useful to put this in a broader political and security context, not just an economic one. Clearly, there are economic reasons for boosting growth in Latin America and we all know what they are. It will help deal with the debt problem and help the United States to export more to what is a very large traditional American market, and that is a contribution to global adjustment.

But I think it's also important to recognize that the Japanese are one of the three pillars of the free world and to the extent the Japanese can contribute to political stability in Latin America that is an important contribution to holding up their end of the bargain in a broader than an economic sense. That is to say, strengthening stability in an important area.

I add to that a point that is of particular strategic importance. That is, if there is instability in Latin America, the United States is going to get politically, if not militarily, bogged down in that. We already see how much time and effort, what's going on in Nicaragua, the Iran-Nicaragua connection takes and how much attention it takes in Washington.

If you get instability in other parts of Latin America with a debate going on as to whether the United States should intervene or play a political role or how does the United States deal with it, that is clearly going to divert America's attention from other responsibilities in the free world and thereby weaken the ability of its allies to defend themselves, not right away but over a period of time.

Therefore, there is a very clear self-interest of the Japanese in strengthening these countries economically, strengthening them politically, and keeping enough political stability so that the United States can maintain a strong interest and a strong security presence in other parts of the world and doesn't have to get diverted to dealing with brush fires in Latin America.

So I would simply conclude by saying that the Japanese are going to be much more competitive financially in the future and we have to accept that as a fact and not shy away from it. American investment banks have just got to be more competitive. They've got to come up with better ideas. They've got to work more closely with their clients. They've got to find way of tapping the Japanese financial market just as the Japanese for years have been tapping the American financial market.

And the Japanese, importantly, have a responsibility to make their financial markets just as open to foreign financial institutions as ours is to theirs because that has to be part of the bargain and that is moving ahead. I commend the Japanese Finance Ministry for the liberalization that has taken place so far and that is much to their credit. The Japanese have liberalized on finance a lot more quickly than some other countries around the world.

But given the fact that they are a big source of financing, it will be more and more a subject of criticism if it appears that foreign borrowers cannot obtain access to this big store of financial resources in Japan on much the same terms as Japanese borrowers. That goes to Lionel's very important point that the cost of capital is vitally important to industry today, particularly the capital-intensive industry, also high tech industry which is also capital-intensive in many cases.

So that equal access to financing so that one country doesn't have a cost advantage in its financing is going to be very important.

The broader point, then, is that the Japanese also, as important members of the free world, have a responsibility to broaden their support not just of countries in East Asia, although that is important in itself, but to look more broadly, to assume broader global responsibilities and provide some support for countries that need it in Latin America.

Over the long run, I think there is no escaping the fact that the United States and Japan are in this together. Without the European alliance the Japanese alliance, the United States will soon cease to become a great power. It needs these alliances and without the close financial connection between the two countries, especially, both countries are going to suffer economically. So these things have to be worked out together.

It's not going to be easy because they are different cultures, different societies and institutions, but it has to be done because the cost of not doing it is so high. Thank you.

[The complete statement of Mr. Hormats follows:]

PRESENTATION OF ROBERT D. HORMATS
VICE PRESIDENT, GOLDMAN SACHS & CO.
BEFORE THE JOINT ECONOMIC COMMITTEE OF THE US CONGRESS
DECEMBER 11, 1986

THE FINANCIAL ROLE AND COMPETITIVENESS OF JAPAN

The formidable financial strength of Japan is a fact of our times. It results from that nation´s enormous trade competitiveness, its high savings rate, and the deregulation of its financial markets. This strength imposes new competitive pressures on the US but also creates new opportunities for mutual benefit.

I hope in this testimony to shed some light on the financial role of Japan in the world economy and what it means to the United States. I begin from the perspective of one who has participated in the making and implementation of US economic policy toward Japan while in government and now works closely with Japanese financial officials, bankers, and business people as an investment banker at Goldman Sachs.

One fundamental conclusion stands out from both perspectives -- the economic rise of Japan has been a modern day phenomena. But it is based not on ´miracles". It is the product of the determined pursuit by the Japanese government of sound domestic economic policies, extremely hard work, and an overwhelming commitment by the entire nation to compete actively in the world economy. To be sure there are legitimate concerns by Japan´s trading partners about market access, Japan's foreign trading practices, and its slowness in turning from heavy reliance on foreign demand to growing efforts to promote domestic demand; but despite these problems -- and even if they were corrected -- Japan would still be a major factor in world trade and finance.

One factor that underpins Japan's financial strength is its high household savings rate -- which is four times greater than that of the US and twice that of Germany and the UK. Reasons for this include a social security system that provides fewer benefits than its US counterpart, thereby increasing incentives for domestic savings; a six day work week; less room in homes and thus less space for large amounts of consumer goods; the difficulty and expense of obtaining mortgages thereby increasing the desire to save large sums for home purchases; and a social code that rejects ostentatious consumption. Moreover, tax policy does not permit interest expenses to be deducted (thereby discouraging borrowing and increasing saving in order to buy what you want), allows interest on savings deposits,and on other types of financial instruments such as trust accounts, and certain new securities to be tax exempt.

Japan also has recorded large trade and current account surpluses -- which go hand in hand with its high savings rate. These savings are, in effect, exported to help other nations to enable them to finance their imports of Japanese goods thereby permitting Japan to continue its large trade surplus. These large trade surpluses in turn earn substantial amounts of money which feeds into the domestic financial system and permits the outflow of still more capital. Both the trade surpluses and outflows of capital have increased because of tight fiscal policies. These have helped cut Japanese real domestic demand growth in half, from about 5% in the late 1970s to roughly 2.5% this year slowing demand for imports and for capital.

The outflow of capital from Japan has led to Japan passing the US as the world's largest creditor nation. By the end of this year it will have a net foreign creditor position of over $200 billion. Thus it has achieved in only four years what it took the US decades to build up. In 1985 Japan's capital outflows exceeded $82 billion, which was nearly twice the amount of its outflows during the 1976-1980 period and 45% higher than in 1984. This year they will approach $100 billion.

For US and European financial institutions, these outflows of capital enable Japanese institutions to boost their international competitiveness. They have access to a broad and deep reservoir of capital, which gives them a vast market into which they can sell securities in vast amounts; this capability clearly enhances the underwriting capacity of Japanese investment banks and provides enormous liquidity for Japan's commercial banks. To quote a recent publication by a colleague of mine "four out of the largest five commercial banks in the world are Japanese; Japanese banks hold 45% of foreign bank assets in the United States and 35% of foreign banks' US business loans -- three times larger than the nearest foreign competitor; sub-LIBOR cost financing for US brokers has become commonplace; the market share of Japanese dealers in Eurobond underwriting has increased tenfold to nearly 25% in just two and a half years; and four large Japanese securities firms are going all-out to gain membership in the select club of primary US Treasury securities dealers."

Let us examine for a moment who the exporters of capital actually are. As of early 1986, life insurance companies held $23 billion of foreign securities; other insurance companies, $5 billion; trust banks,$25 billion; investment trusts, $12 billion; the post office, $5 billion. Most of the rest is accounted for by banks through direct loans, interbank loans. or direct investment. Of the long-term capital outflow the bulk has been in the form of bond purchases -- some Treasury issues and some by corporations. In 1985, Japanese institutions purchased $19 billion in Treasury notes and bonds. That came to 64% of Treasury notes and bonds purchased by all foreigners, and 13% of net new Treasury financing in notes and bonds, and 23% of Japanese long-term capital outflows. But in the first half of this year, these institutions purchased only $2 billion of Treasury notes and bonds.

There are in this situation, clear implications for the US financial industry. It will surely create additional competition. This must be expected and responded to by greater competitiveness on the part of US commercial and investment banks. While Japanese securities firms have not yet developed the major placing power of large US investment banks in the large US market, they clearly have it in their own. This permits them to bid aggressively to obtain underwriting assignments from issuers of securities -- who more and more want to denominate them in yen to attract Japanese investors -- with the confidence that they can sell these securities in their large domestic market base. This practice is not unlike that of some Swiss banks, who also have a history of agressively bidding for securities in the knowledge that they can place them in accounts which they control. But because American investment banks "control" few portfolios, and instead must sell securities to pension funds, insurance companies, investment trusts, banks and individuals they often cannot bid as aggressively with the same confidence because they would suffer losses if they did so and then could not sell the securities they had taken on to their books.

This having been said, however, the US financial industry cannot go the way of other industries faced with foreign competition. It must continue to come up with new financing concepts and techniques that meet the precise need of issuers and buyers of securities, work closely with clients to help them identify profitable financial transactions, and help business to avert risk through the use of advanced currency hedging techniques and measures to reduce the impact of interest rate volatility. And the Japanese should operate in the spirit of avoiding actions that disrupt financial markets in the short run thereby harming the ability of these markets to fulfill their role over the longer term.

The US government will also have to recognize the its bond market depends heavily on imported capital. The low US savings rate coupled with large capital needs -- both corporate and government (through the federal deficit) -- and high consumption means that the

US must import capital; and the largest supplier of that capital is Japan. But to keep this capital coming, domestic conditions here must be right. If interest rates fall too low relative to those abroad, Japanese holders of capital will be reluctant to purchase US securities and may hold off lending to American borrowers in dollars until interest rates rise. Or, if foreign holders of capital believe that the US dollar will fall further, they may hold off buying US Treasury bonds at the existing currency rate, hoping that they can buy them later at a more favorable currency rate, thereby pushing the dollar further down.

We need also to see if there are ways by which the Japanese government can give incentives to private holders of capital to channel some of their funds into productive uses in developing countries whose high debt constrains their growth and thus their imports from the US. Japanese investment has tended to be concentrated in Asia. Of the local subsidiaries of Japanese countries (total 3,969) 1,523 are located in Asia, including 826 in ASEAN, 826 in the US, 587 in Europe, and 503 in Latin America.

Myriad proposals have been advanced to induce Japan to lend to and invest in Latin America. But we cannot expect Japan to put money into overly risky projects in countries whose national economic policies are inappropriate. But where there are sound borrowers and good policies the Japanese -- through guarantees by their Ex-Im Bank -- should support sales of needed capital and spare parts from the US, Europe as well as Japan to Latin America and other high debt nations. And it can help to finance increased Latin American exports to Japan. Finally, the Japanese government should encourage Japanese companies to invest more in Latin America -- perhaps through the use of temporary tax incentives -- thereby bringing with it capital, technology, and new jobs.

Mr. **Olmer**. Thank you, Bob.

We've got about 25 minutes to go and I think there may be time, with the chairman's consent to ask for questions from the audience, but before I do that I would like to ask, do you have any comments that you want to make?

Representative **Obey**. I'll just comment at the end.

Mr. **Olmer**. I jotted down a number of questions myself. I would rather be in the position of an intellocutor who has no responsibility to make a substantive comment but just to prod.

It seems to me that a central question to be answered is whether or not there exists a will to change on the part of those who control the regulatory regime in Japan, and I wonder if Bob would like to comment on that.

Mr. **Hormats**. Well, you and Kent have been there more recently than I, but I will give you a general comment.

I think there is a will on the part of a number of Japanese who have spent time dealing with some of the broader international financial issues.

I think that, for instance, the people I have talked to in this Finance Ministry have a very deep understanding of the importance of the Japanese making the sorts of changes which would put the country and its financial regime pretty much on the same level as other countries.

But I think it's also the case that there is an entrenched school of thought and an entrenched bureaucratic establishment which is intent on moving very slowly, and I think that there are a lot of Diet members particularly who see no great need to accommodate foreign interests when it comes to regulatory questions.

Why is this? Because they are people who have come to power through the local level. They have had relatively little experience in the world economy. They have worked in their areas to gain power. They have worked in the LDP to gain power and they really have not been exposed to nor do I think they recognize just how influential Japan is in the world economy today.

Americans after World War II understood that the United States was the key power. If the Americans didn't make the world economy work, it wouldn't work. Most Americans I think, thanks to Roosevelt and Truman who made this point repeatedly in their speeches, repeatedly over a course of 15 years made that point—without that, I think Americans wouldn't have appreciated it. But we went through a war. America was the only surviving power that had the ability to make the political system and economic system work and to maintain the world's security, and Americans recognized this role.

It's very hard for an economy which has a history which is quite different from ours to get the political level of support to make those changes.

Mr. **Olmer**. I don't believe that there is a single occasion when I have visited Japan in the course of the last 28 years that I have not received at least one lecture on Japan being an island nation bereft of natural resources. Sometimes I get the lecture from the same person, which suggests they have very little faith in my retentive abilities.

I think that it is a fact thay many people in Japan in high places are still very seized with that notion. It is, of course, true, but there are a lot of things about it which are less significant than the bold statement itself.

The Maekawa Report which has been referred to by me and others earlier today is an extraordinary document. It is sweeping in the proposed changes that are contained within it. Some of them, in my own view, are probably not in Japan's interests to immediately attempt to implement and I think that perhaps some of the recommendations in the initial report were contrived largely to appease outside pressures and perhaps didn't sufficiently take into account the internal domestic realities, the difficulty of implementing such an extraordinary reshaping of Japanese society.

It seems to me that we too often ask of others that which we are unprepared to do for ourselves and certainly in the area of managing our fiscal account that seems to be true.

Mr. **Calder**. If I might perhaps just add a word there. I would agree with everything which Lionel and Bob have been saying but would add two points.

First of all, I think that both major Japanese regulatory authorities the Ministry of Finance and probably even more so the Bank of Japan recognize that there are some unstoppable forces in motion in the area of finance. These forces make finance, together with telecommunications, very different in terms of political economy from agriculture, and the labor-intensive industries.

One thing is the emergence of Japanese capital markets. The scale of the Japanese budget deficit in the 1970's was so large that the Ministry of Finance simply was unable to continue underwriting the bonds and so on through a syndicate as it had previously. Driven by both the Japanese debt and by the internationalization of the financial system, we have seen a breakdown of regulatory barriers by international market forces. Even if they wanted to, the Finance Ministry could not.

That brings me to the second point, which is that in finance, as in telecommunications, but not as in a range of the traditional manufacturing sectors, you also have powerful corporate interests which are moving very actively into the world market. They have a strong stake in how world markets evolve and whether Japan will be kept out of them or not, as well as in the kind of treatment that they get in this country.

Such concerns make these Japanese companies something of a force within Japan for awarding a certain level of favorable treatment to our firms. Of course, if we don't know what we want or if we don't coordinate or if government and business don't have a sense for what the issues are, parochial Japanese interest groups, will undoubtedly hold sway. But there's something different about finance and about telecommunications from most other sectors in this regard.

Mr. **Olmer**. In Japan, of course, the ministry that regulates the postal savings system is the same ministry that regulates telecommunications and I think that it is worth pointing out that one of the successful negotiations, apart from beef and citrus, over the course of the last recent period has been in the effort to get Japan to more rapidly deregulate its telecommunications system.

That has been underway and it is underway and the pressure for it to accelerate is coming from within Japanese industry, a Japanese industry that wants to avail itself of the latest state-of-the-art in the telecommuications services sector, not so much in this aspect in the manufactured goods that are available on both world markets and from domestic Japanese suppliers, but in the services which are available that support international financial transactions.

I wonder if anyone in the audience would like to pose a question to any of the three of us here.

VOICE. I think the case for, shall be say, redirecting Japanese energies in Bob Hormats' paper and getting Japan to lend and invest more in Latin America is an overpowering position.

What I also find myself concerned with, however, is that in the area of trade both you and Bob Hormats who have spent a lot of time worrying about, that the United States seems to find itself in a position of advocating another strategy on the part of the Japanese.

Are there any political incentives, if not economic and financial incentives, that the United States can provide the Japanese with to do what is obviously an eminently sensible and necessary course of action?

Mr. HORMATS. It's a good question. I think it goes to the point that the Japanese themselves have to understand more clearly and that is that their economic wealth confers upon them a political and a security responsibility.

Now how they manifest that responsibility, of course, is somthing we can't fine-tune for them. They have an understandable reluctance to strengthen their military as dramatically as, say Cap Weinberger might want. But is they don't want to do that—and I can see why they don't—I wouldn't argue against the Japanese position on that, but if they don't want to do that, they can still contribute to global political stability and security through the use of their foreign assistance or their Ex-Im Bank or other things.

The fact is, you can't be a wealthy country and simply not do anything or not carry your own weight in the world political scene and there are ways that I think they can come to understand that they do have some sort of political responsibility, and Latin America is a place where they can manifest that. And the numbers will follow once they come to that basic political judgment.

But it is an area, except for Brazil and maybe Chile to a degree and very recently Mexico, where they have not really sensed that they have a responsibility and I can understand historically that they don't, but now it's a global economy and a global political system and if something goes wrong in Latin America, the Americans will clearly have to deal with the problem. That's us. But the Japanese will indirectly suffer because the inattention of the United States to its other alliances will become a problem.

If you go back in history, the times when the United States has gotten preoccupied with Latin America—the Bay of Pigs is a good example, the overthrow of Allende, you name it, four or five times in the last 25 years—every one of those times has provoked some sort of crisis in American security alliances to one degree or another. That tends to create these divisions which can only weaken

Japanese security. They have to come to understand those linkages. They can't have one without the other.

Mr. CALDER. Maybe just a word there. I think in terms of incentives, in terms of symbolic incentives, one area could conceivably be in some of the multilateral institutions which are dealing with major global problems. For example, at the IMF we have had a European executive director since the fund was begun. At some point, given Japan's role in the international financial system, a more responsible position for Japan in the IMF would make sense.

Basically, a predictable order of trade relations, some degree of stability, is what most Japanese want—not necessarily an order that gives them all the benefits even of the status quo, but something which is predictable. Some sort of an institutionalized framework which is relatively predictable is important for a nation which has always been so preoccupied with the instability and the vulnerability of its position.

Mr. OLMER. I had jotted down a question during the course of the remarks by the other two panelists that may help at least give you an appreciation of my thinking and it was: Is it realistic to believe that Japan will extend credit for export sales to Latin America by United States and European companies?

And having asked the question, I guess I owe an answer. And I think it is not likely. It is not reasonable to expect that in the immediate term.

I think Bob Hormats has laid the philosophical groundwork for an unassailable verity. Everything he said is absolutely true. Japan must recognize its responsibilities as a world power, given that it has become such an economic giant. But how it should do that and in what ways it should be manifested and how an outsider could articulate it and how outsiders might even conceive that in a Japanese political framework it would be articulated is another matter. And I have the greatest regard for the people who put together Japan's economic and foreign policy structure. They are eminently capable and far-reaching, understanding individuals who have served all around the world and yet I do not sense a coming to grips with this globalization of Japan other than the recognition of its economic might.

There still is a decoupling of the economic side from the larger political context that Bob I think has been saving for years. It's no criticism or discredit, but it is not exactly a fresh thought. Many of us have been saying it for quite some time.

Mr. ICHIMURA. I just want to say to many Japanese policymakers and executives that what is needed is to pull Japan into the international and global forum more intensively. We do not seem to have enough policymakers and politicians who have a good understanding of that and it is urgently needed to pull them into the international forum. The IMF is one place. The United Nations is another place. The OECD made a great contribution to let the Japanese participate in the international debates.

Now I do think I would like to say that there are some arguments in Japan to establish another World Bank rather than requesting more of a share in the World Bank set up now. So some such new devices might be needed to pull Japan more into the international forum.

Mr. HORMATS. Could I just make a point on history here?

People take it for granted that the United States plays this world role and that it was always so. But if you go back to the early part of World War II, most Americans didn't even want to aid Britain. This was not a country which by some act of God has historically played a responsible global role.

In the early part of World War II, the President had to devise the lend-lease program so he wouldn't have to say the United States was giving arms to Great Britain when it was fighting Germany. And it was really the power and persuasiveness of one individual. I mean, it wasn't a national groundswell. The world didn't say that America had to do this. One person, and obviously there were people around him, but one person through a substantial, enormous exercise of leadership said in speech, after speech, after speech, and twisted arms of the Congress. There was no support in the Congress for this and he did it.

Now why did he do it? It's because he understood that if he didn't do it, it wouldn't happen. It wouldn't happen by some sort of automatic groundswell of support. No one was going to do it if he didn't get out and do it.

Now I think Prime Minister Nakasone has made a lot of efforts in this respect, but what I'm saying is, if there is not a substantial amount of effort by the leadership of a country, it's highly unlikely to happen.

Now it may well be that Japan because the system works differently, one person is going to have to stand up and do for Japan what Roosevelt did so successfully here and Truman after him. But it requires someone repeatedly making a national interest argument on behalf of it. Unless people do that and it has to be a clarion call—it can't be maybe here or maybe there. Without that—it didn't happen here. It's not automatic. That's my point.

VOICE. I'd like to address a question to anybody on the panel. We have been talking about the Japanese economic resources and this has involved also the security question.

I wonder what the Japanese reaction would be to a proposal that they share the burden of the economic costs of the American bases in the Philippines which for the most part really assist in the security of Japan?

Mr. OLMER. Any volunteers?

Mr. CALDER. Perhaps just a few words about this. I think it's instructive to look at the Japanese response to the Aquino request for very substantial loans during her recent visit to Tokyo. Japan has offered, as you know, substantially more than the United States did, but not nearly as much as President Cory Aquino requested. And there has been quite a vigorous debate behind the scenes in Japan as to the propriety of both the Aquino request and the Nakasone offer.

Of course, all that hasn't been tied directly to the bases question. My guess would be that Japanese support for the Philippines probably would be much more controversial in Japan if it were tied in some explicit way to national security.

We can take the example of the Koreans 4 years ago. Korea made a demand for something more than $4 billion in loans from Japan on the grounds that it was contributing to Japan's national security. The Korean demand seems to have stirred a good deal of resentment in Japan.

So I suppose that just says something about the current state of Japanese politics.

Mr. OLMER. My suspicion is that there would be serious criticism within the Philippines to direct investment by Japan in military facilities in the Philippine Islands.

Representative OBEY. We are really about 20 minutes over, so let me just forego asking any questions and thank the panelists and once again especially the moderator, Mr. Olmer, who as usual has done a penetrating job.

I should explain that we had originally also wanted John Heimann from Merrill Lynch to be with us, but he is stuck in Hong Kong and could not get back as we had originally hoped.

Thank you again for coming. We resume at 2 o'clock with the next panel. [Applause.]

[Whereupon, at 12:55 p.m., the committee recessed, to reconvene at 2 p.m., the same day.]

AFTERNOON SESSION

Representative OBEY. This afternoon we resume the subject matter that we were dealing with this morning and turn to an examination of the emerging economic powers in the Asian Pacific area in the Newly Industrialized Countries of Taiwan, Singapore, Hong Kong, and South Korea; and the somewhat more slowly industrializing but resource rich countries of Malaysia, the Philippines, Thailand, and Indonesia.

Together, these countries constitute a major source of economic dynamism in the region and the economic relationships which they establish with one another and with Japan are likely to be a key influence on the future evolution of the entire Pacific Rim.

Their low labor costs and rapid productivity growth have made them major players and we have every expectation that they will become even more major players in the coming years.

Understanding the changes taking place in that region will be as important to our future economic ties in the Pacific Rim as understanding the changes that have taken place in Japan.

We have another distinguished panel and moderating this panel will be Bruce Stokes, who writes extensively on the competitive challenge of the countries involved for the National Journal. In addition, Mr. Stokes has recently been named a fellow of the United States-Japan Leadership Program of the Japan Society. Bruce, why don't you take it from here.

Panel 3.—Bruce Stokes, Moderator

Mr. STOKES. Thanks, Congressman.

I might say the panel is to be congratulated for focusing at least part of its time on the newly developing and newly industrializing countries of East Asia. They certainly do pose a challenge that is, while not equal to that of Japan, one that looms in the future as a major challenge and in many ways is far more complicated and much more difficult to deal with in the long run.

Unfortunately, our Government and our society are very short on long-term planning and it probably is good to begin to think beyond Japan at this juncture while we're still focusing on the Japanese challenge, to realize that once that problem is dealt with there will be others to follow.

We need to look no further than the trade deficit figures with some of the East Asian NIC's to see why that is a problem. Already, South Korea and Taiwan, after 10 months of 1986, have surpassed their trade surpluses of all of 1985 with the United States, and will have record high trade surpluses with the United States.

While, fortunately, from a U.S. perspective, the monthly trade data show an improvement in our trade deficits—in other words, the trade deficit is not increasing as rapidly as it was, say, in July—it is still much higher with Taiwan or South Korea than it was a year ago in October of 1985, 40 or 50 percent higher for those two countries, and higher for Hong Kong as well.

So we do have a problem that has gotten very much out of hand—a trade problem—with some of the East Asian NIC's, one that, unfortunately, the Government has only begun to think about. The Reagan administration has now begun to focus some attention on Taiwan and South Korea in particular—begun to try to do something about the fact that their currencies are linked to our currencies and pegged to our currencies in a way that make it very difficult to have great influence on the trade imbalance.

The Koreans will be allowing, as I understand it, the—to appreciate a bit in the new year, which is useful from a trade perspective to the United States.

But that, of course, only deals with some of the short-term problems and I think we have yet to really deal with the long-term challenges posed by these nations.

Taiwan, for example, has very explicit strategy of focusing on high technology and developing high technology. IBM, for example, has its first relationship with a non-IBM firm in Taiwan where it is doing research and development in Taiwan under contract with a Taiwanese company, the first time IBM has ever gone outside its own family for this. Ths reason is quite adequate. They are getting Cal Tech and MIT trained engineers and scientists at a third the cost they can here in the United States.

So the challenge from the NIC's if not now at least in the future may well be not just in automobiles, steel, and textiles, but in high technology and certain services. And as we begin to develop policy responses to that challenge, I think we may find that the challenge in developing policies is much different than it will be with Japan. Each of these countries is separate; they're different. In many ways, we have greater leverage over them because they are smaller and some of them are militarily dependent upon us.

By the same token, there's an integration of their economies and our economics that really does not exist in the same way as it does with Japan. They are far more integrated into our economies and certain changes we make in our competitive nature may in fact benefit them more than harm them. And I'm thinking in particular as we begin to improve our educational system as far greater proportion of their engineers and scientists are trained in this country than are Japanese engineers and scientists. As a result as we improve our own educational system we may well be improving their educational base as well. As we change our tax laws to deal with R&D we may in fact—there is some fear in this town that we may force more R&D overseas and the likely location may well be some of these NCI's.

Probably the most important policy challenge we face is to begin to think about the kind of changes we would like to see in their economies to make them more responsible players in the international realm. We are already beginning to work on the Japanese in that vein to get them to import more, become more consumer oriented and less a production oriented economy. We also need to begin to think about establishing a dialog with the Taiwanese and the Koreans and so forth to start that process a little earlier on than we have with the Japanese.

The East Asian NIC's markets are as closed certainly to some of the lesser developed countries as the Japanese market is to American goods or to Korean or Taiwanese goods. So we need to begin to work on those issues as well.

Certainly this panel I think is one of the beginnings of creating an agenda for the new Congress on those issues and hopefully involving the administration in that same process.

We have a panel of four distinguished authorities on the Asian NIC's and we will hear from each one of them. Our first panelist is Professor Seiji Naya, who is currently the director of the Resource Systems Institute, East-West Center in Honolulu, and formerly the chief economist at the Asian Development Bank, and he will be talking about investment and trade opportunities with the NIC's and their relationships with the United States.

STATEMENT OF SEIJI NAYA, DIRECTOR, RESOURCE SYSTEMS INSTITUTE, EAST-WEST CENTER, HONOLULU, HI

Mr. **Naya**. Thank you very much, Mr. Stokes, Congressman Obey, fellow panelists, ladies, and gentlemen, I would like to thank the Joint Economic Committee for inviting me to this symposium. I am very pleased to speak on trade investment opportunities the United States has in this very dynamic part of the world, as Mr. Stokes pointed out a little while ago.

In looking at the relationship between the United States and the NIC's and ASEAN countries, I feel there are two different ways of looking at these countries.

First, the rapid economic growth and outward-looking policies of Hong Kong, Singapore, and Taiwan have made them models of economic development. These countries are shining examples of the kinds of market-oriented, private-sector-based, outward-looking policies that the United States has long favored. Their success has ecouraged other developing countries, such as members of the Association of Southeast Asian Nations; namely, ASEAN, and more recently, the South Asian countries and China to emulate the kind of policies the NIC's have followed in the past.

The United States has played an important role in assisting the development efforts of these countries and should continue to do so. At the same time, developing Asian countries, especially NIC's and

ASEAN countries, are large, growing markets for American exports and investment.

However, there is a second way of looking at the rapid growth of output and exports of these countries. U.S. imports from these countries have increased quickly in the past several years—in fact, the past 20 years. All four NIC's now have trade surpluses with the United States. All of them will even have current account surpluses this year.

For ASEAN, Japan is still the largest trading partner, but Japanese imports from ASEAN countries consist largely of primary products, agricultural and raw materials items. As these ASEAN countries have increased the pace of industrialization, the U.S. has become an important market for their labor-intensive products. In fact, most of ASEAN exports of manufactured goods go to the United States rather than to Japan.

Although Asian developing countries account for a small share to the U.S. trade deficit, some people perceive these countries as a threat to the United States. They view the U.S. deficit with these countries as qualitatively the same, only quantitatively smaller than the U.S. deficit with Japan.

There is a tendency to look at these countries as little Japans, taking away American jobs and reducing our standard of living.

I strongly believe that it is a mistake to consider the success of these countries in this manner. It is important to keep in mind that these countries are still very poor. While Japan's per capita income level is close to that of the United States—and Mr. Krause will say that it is in fact, higher after the exchange rate realignment—setting aside two small city states, Hong Kong and Singapore, per capital income ranged from about $3,000 for Taiwan, and $2,000 for Malaysia and Korea to about $900 for Thailand and about $600 a year for Indonesia. This means that the American per captia income is about 30 times that of Indonesia.

Also, Korea and all ASEAN countries have a great deal of foreign debt and their debt service payments are extremely high.

I mentioned earlier the importance of these Asian countries for American trade and investment. In fact, this is the only region where the United States has out competed Japan in terms of exports. The NIC's imports from the United States have risen rapidly, much faster than their total imports and their imports from Japan.

U.S. export figures show that our exports to NIC's and ASEAN, expecially NIC's, have grown very rapidly. Not long ago, we exported only about 6 percent of our total exports to this region. Today, over 11 percent of our exports are directed to these countries. This is just about comparable to our exports to Japan. In fact, you will be surprised to find that our exports to NIC's and ASEAN comprise nearly the same share as our exports to Latin America. Your would think that Latin America would be our largest trading partner as far as developing countries are concerned, but I think the NIC's and ASEAN will surpass Latin America very shortly.

Moreover our exports to these countries are concentrated in areas where we have comparable advantage, heavy machinery, chemicals, and other capital- and technology-intensive goods. It is expected that demand for equipment and capital goods will continue to expand as these countries continue to grow.

I do not mean to imply that our deficit with these countries is trivial. In fact, it is quite large, as our chairman pointed out. But our trade deficit with these countries, in fact, has been declining proportionately in the last several years. The trade deficit with NIC's and ASEAN has gone down in relation to total trade deficit.

In addition, the recent change in the exchange rate makes our goods more competitive relative to Japanese goods. Thus, this is a very opportune time for us to push for more exports to these countries.

Nevertheless, it is very important that these Asian countries, especially Korea and Taiwan, should be pushing for greater trade liberalization. They have been doing this in recent years but there is room for greater trade liberalization.

These countries in the past have pushed export promotion a great deal, but that does not mean that their imports are liberalized. In fact, in many areas they still maintain highly restrictive import policies and I feel this is a very good time for us to push for their trade liberalization.

The United States has been pushing for Korea and Taiwan, especially Taiwan, to revalue their currencies as well. However, I feel that in Korea and to a lesser extent, Taiwan, because of their numerous restrictions their exchange rates are somewhat overvalued. I believe, therefore, that it is better to push for greater trade liberalization than for revaluation of their currencies at the moment. This is especially true in Korea which has an extremely large debt payment.

Finally, I'd like to point out the tremendous interaction between trade and investment. Traditionally, we think of trade and investment as being substitutes, but in the case of Asian countries you find exports complement our investment as well. Recent Commerce Department statistics point out that, in fact, the exports generated from our investments have been much larger than imports generated.

So in the area of foreign investment as well, we certainly should take advantage of the growing opportunity in these countries. This is a very opportune time for the United States to invest more in these countries.

There are basically two fatigues affecting these countries. One is what is known as aid fatigue. Developed countries are quite reluctant to provide more aid in recent years. Also, there is debt fatigue. Most commercial banks have been burned with their past lending to developing countries. They are quite reluctant to lend their bank loans to these countries, and also the developing countries themselves have been quite reluctant to borrow. Certainly, I agree with that attitude.

What is needed is more financing rather than borrowing and lending. In the case of financing, certain direct foreign investment is a major part of direct financing without incurring additional debt.

In the last several years the attitude toward foreign investment has been changing in these countries. Ten years or so ago, foreign investment had negative connotations. They felt that foreign investors exploited their economies, but recently they are more willing to accept foreign investment. In fact, they are making policy changes to attract more foreign investment.

Contrary to popular belief, foreign investment in Asian countries is actually a very small part of their total investment. If you set aside Singapore and Hong Kong, foreign investment is less than 5 percent of their total domestic investment. This indicates that there is room for more foreign investment in these countries.

It is commonly believed that Japanese investment has out-competed American investment in the NIC's and ASEAN countries. This can be explained by the nature of Japanese investment. Japanese investment tends to be in the preferred sectors with host country participation and host country partners. American investment, on the other hand tends to be high technology, much more resource-intensive, capital-intensive types of investment. Therefore, the American firms tend to prefer wholly owned subsidiaries rather than joint ventures with Asian countries.

Furthermore, you will find that many small and medium Japanese firms have been quite successful. One reason for their success is because there are usually three partners in Japanese investment. The small- and medium-size Japanese producers are combined with local partners and with trading firms. Trading firms provide marketing knowledge, provide financial package and consult these firms.

In the United States, we began to move in this direction with the introduction of what is known as the Export Trading Company Act in 1982, but as I understand it, that has not been effective and there is more that needs to be done in this area in the future.

On the other hand, the recent statistics surprisingly show that the strong position of Japanese investment in NIC's and ASEAN lessened considerably. In fact, the United States has been investing more in these countries.

Before the sharp increase in our investment to NIC's and ASEAN countries about 7 or 8 years ago, American investment in NIC's and ASEAN comprised only 3 percent of our total investment. Today, it is over 6 percent, much larger than our investment in Japan.

Furthermore, the rate of return on direct foreign investment in Asia, or the income from our investment from Asian countries has been much larger proportionately than our stock of foreign investment. Our direct investment is about 6 percent of the total. Income from our investment has been about 17 percent. This indicates that our investment has been quite profitable in this part of the world.

In conclusion, I'd like to point out that some of these countries' economic growth rates have slowed down in the 1980s. The ASEAN countries are especially having difficulties, but I feel they will not stay down very long. The dynamism and market orientation of these countries will continue to provide tremendous trade and investment opportunities in a wide variety of areas.

It is important for the United States to participate rather than retreat from the increasing interdependence in the region. American businesses need to reach out and actively participate and take advantage of these trade and investment opportunities in Asia.

Commercial policies of the United States, as well as Japan, have had large impacts on the region. Failure to achieve market opening by Japan could lead to wide-ranging United States restrictions which could negatively affect neighboring countries; namely, ASEAN and NIC's.

We must promote industries in which we have a comparative advantage to regain our competitiveness. The United States has much to gain from increasing interdependence with the world economy. Business is essential for healthy U.S. economic growth. Thank you very much.

[The complete statement of Mr. Naya follows:]

TRADE AND INVESTMENT OPPORTUNITIES IN THE NICs AND ASEAN COUNTRIES AND THE ROLE OF THE UNITED STATES

BY

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Trade and Investment Opportunities in the NICs and ASEAN Countries and the Role of the United States

by
Seiji Naya

I. Introduction

The economic dynamism and the growing importance to world trade and industry of the developing countries in the Asia-Pacific region, particularly several countries in East and Southeast Asia, have stimulated a great deal of interest in the Pacific.

This paper focuses on trade and investment issues affecting U.S. competitiveness in the Asia-Pacific region. It begins by looking at characteristics of these countries. Their outward-looking, market-oriented policies have been the key factor for their rapid economic growth, but their openness to world trade has made them vulnerable to changing external conditions. Growth rates have slowed in the 1980s, especially for some Southeast Asian countries. Some of the problems they have to confront is also discussed in Section III. After providing some background on these countries, the paper examines some problems in the area of trade within the Asia-Pacific region and some options to enhance international cooperation. The next section then looks at the U.S. direct foreign investment position in these countries and opportunities for U.S. firms.

In the past 20 years, countries in the Asia-Pacific region have had high rates of economic growth. The United States and Japan are the two largest industrial countries in the region. But it is not the U.S. or Japan that have been growing rapidly in recent years. In fact, the Japanese growth rate in the last 15 years has slowed to about 4 to 5 percent. The slowdown was especially apparent in the 1980s; it will be about 2.5 percent this year. U.S. growth rates have averaged about 2 to 3 percent. Rather, it is the countries surrounding Japan, the developing countries in the Asia-Pacific region, that have been growing very rapidly. The East Asian countries--Hong Kong, Korea, Taiwan--and one ASEAN member, Singapore, have been growing so rapidly over the past two decades that they are often called "newly industrializing countries" or NICs. They have maintained average economic growth rates of 8 and 9 percent in the 1970s and about 6 percent in the 1980s, making them among the fastest growing in the world (Table 1).[1] Per capita income also grew rapidly, averaging 6 and 7 percent over the past 20 years.

The resource-rich members of the Association of Southeast Asian Countries (ASEAN)--Indonesia, Malaysia, and Thailand--also had strong economic performance. Table 1 shows that their economic growth rates are somewhat lower than those of the NICs, but they have also done very well for the last 20 years or so. The only exception is the Philippines, which has new prospects for growth under the new government.

These countries have been open to foreign trade and investment. Export-to-income ratios are high, ranging from 21 percent for the Philippines to more than 100 percent for Hong Kong. In comparison, the ratios for the United States and even for Japan were lower, about 8 and 17 percent, respectively. Many people believe that Japan relies almost totally on the external market. In fact, they are quite domestic-market oriented, although they have become more export-oriented since 1970. Japan has concentrated exports in a few very visible industries which have grown very rapidly.

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[1] Tables are located at the end of the text.

Interdependence between the United States, Japan, and the Asian developing region has increased dramatically in the last two decades. Since the 1960s, the expansion of trade and investment linkages between the United States and the developing Asian countries has been strong. U.S. economic growth has been a favorable factor in the region's dynamism. Increasingly, the U.S. itself has looked to fast-growing Asian markets to facilitate its own growth. The high rate of economic growth in the region has meant increasing demand for U.S. exports and foreign investment. It is one of the few regions in the world to which the U.S. has increased its export market shares in the 1980s.

Recently, however, economic growth has slowed in several Asian developing countries. It was especially bad in 1985; Singapore experienced negative real economic growth for the first time in more than 15 years. The NICs, however, have recently increased their competitiveness with the appreciation of the yen and have improved their economic performance. The four ASEAN countries have not been as successful. Indonesia, Malaysia, the Philippines and Thailand (henceforth, ASEAN-4), have had lower real economic growth rates in the 1980s. Growth in Indonesia and Malaysia dropped to below 3 percent in 1985 and may drop even further in 1986. The Philippines experienced negative growth in 1984 and 1985. In 1986, there is a chance growth will be positive but the country will continue to struggle in the immediate future. Thailand has fared better than most with growth continuing at around 5 percent.

Several changes in the international environment have especially affected the growth of these countries. First, commodity prices fell in the 1980s. The sharp decline in commodity prices have hurt the ASEAN-4 countries as they are heavily dependent on primary commodity exports. They have had, on average, almost no growth in exports between 1980 and 1985 (Table 2). Oil price declines benefitted the NICs, Thailand and the Philippines, but forced oil-exporting Indonesia and Malaysia to severely restrict import growth. Second, growth rates in the industrial countries declined in the mid 1980s, resulting in a decreased demand for manufactured imports by these nations. The slowdown in the United States, a major importer of manufactured goods from these countries (particularly from the NICs), was especially important. Thus, the real growth of world trade was stagnant in the 1980s (Table 3). Fourth, the threat of protectionism also increased uncertainty and slowed growth. Finally, imbalances in the external and fiscal accounts of several Asian developing countries, particularly in the face of high debt servicing requirements, led to austerity policies and further limited the scope for economic expansion.

In light of the slower growth in world trade and increasing protectionism, many people have begun to question whether the outward-looking development strategies adopted by these countries are viable in the future. Outward-looking strategies were a key to the success of the NICs in the 1960s and 1970s when they were virtually the only countries to follow such policies. But their success encouraged other countries to adopt similar policy directions, and problems associated with such policies became apparent. Outward-looking policies increase trade dependency and integrate the domestic economy into the global economy. Externally-generated problems increase. The question is then--should the Asian developing countries continue on their path toward increasing liberalization of their economies?

A large part of the answer to this question relates to policies taken with respect to these countries by the United States and Japan, the two largest trade and investment partners of these countries. In the United States, it has recently become popular to look at these countries as "little Japans", taking away American jobs and reducing our standard of living. Though the Asian developing countries account for a very small share of the U.S. trade deficit, there is a natural tendency to view U.S. deficits with these countries as qualitatively the same and only quantitatively smaller than that with Japan. The growth of U.S. trade deficits with these countries has created a major conflict.

However, there is a danger in viewing Japan, and other export-oriented Asian countries as one and the same. It is important to keep in perspective the sharply different levels of economic development and divergent structural economic features of these countries. Japan has a per capita income level that is close (and some argue higher) to the U.S. level. The Asian developing countries, on the other hand, are growing economically but are still poor countries. Setting aside the two small city-states of Singapore and Hong Kong with per capita incomes less than half that of the United States, per capita income ranges from about $3,000 in Taiwan and $2,000 in Korea and Malaysia, to between $600 and $900 in Indonesia, the Philippines and Thailand (Table 4). The U.S. per capita income is nearly 30 times higher than that of the poorest ASEAN country, Indonesia. Moreover, Korea and the ASEAN-4 countries are among the largest debtors of developing countries. Large debt servicing requirements consume a large share of their export revenues.

Rather than viewing these developing countries as a threat, I would hope that the U.S. would take the view that these countries are shining examples of the kinds of market-oriented, outward-looking policies that the U.S. has favored. The dynamism of these NICs has made them a model of development. Their success over the past two decades has encouraged other developing countries, such as the members of the Association of Southeast Asian Nations (ASEAN), and more recently some South Asian countries and China, to emulate the policies of the NICs. The U.S. has played an important part in assisting the development efforts of these countries, and should continue to do so. Protectionism by the U.S. against these countries may push them backward in their efforts toward development.

Yet, the trade frictions between the U.S. and the Asian developing countries must be resolved. It is hoped that the U.S. will refrain from protecting declining industries and instead, encourage smoother structural adjustment of our economy. In addition, we need to work to increase the competitiveness of our exports to take advantage of the dynamic growth of the region. The depreciation of the U.S. dollar _vis-a-vis_ the Japanese yen makes this an especially opportune time to push export and foreign investment growth.

II. _The Asian Developing Economies_

Diversity characterizes the Asian LDCs. They range widely in terms of size, per capita income, resource endowment, and level of industrialization. The NICs are classified by the World Bank as upper middle-income countries, though Hong Kong and Singapore can be said to have almost graduated from the ranks of developing countries. They are highly industrialized; the manufacturing sector comprised the bulk of total exports for Hong Kong, Korea, and Taiwan and nearly 50 percent for Singapore. It accounted for between 24 and 41 percent of gross domestic product (GDP) in 1985, and between 24 and 36 percent of employment (Table 5 and 6). Hong Kong and Singapore also have highly developed service sectors and are major financial centers in Asia.

ASEAN-4 countries generally have lower levels of income and industrialization. With the exception of Malaysia, which is classified as an upper middle-income country, they fall into the World Bank classification of middle-income countries. They have had to work out industrialization strategies under different internal conditions than the NICs. A major difficulty in these more agricultural economies is the wide gap in technology and skills found between the rural traditional economy and modern industry. Large, fast-growing and predominantly rural populations are difficult to equip with the skills needed for rapid industrialization. Early on "industrial development" has concentrated on extraction of natural resources and replacement of imported consumer goods by domestic production. These industries tended to be rather capital intensive and had few linkages with the rural sector. It is not surprising, therefore, that although the manufacturing sector comprises nearly 20 percent of output in Malaysia, the Philippines, and Thailand, its share in employment is 15 percent in Malaysia and less than 10 percent in the other countries. After a spurt of relatively fast growth of protected industries, growth was limited to the rate of expansion of domestic demand. Ultimately, growth under the inward-looking strategies depended on incomes in the rural economy. Rapid agricultural development since the late 1960s allowed growth to continue. But as of yet, these countries have not really succeeded in creating the type of dynamic industrial sectors found in the NICs. ASEAN countries need to move faster toward outward looking policies as they rely more on labor-intensive industrialization and processing of primary products in the future.

III. Factors for Success and Problems in the 1980s

Although several of the Asian developing countries have faced problems in recent years, they have had phenomenal success over a long period and their long-run growth prospects remain strong. Several factors are observed to be important in their achievement of strong economic growth. This section will look at reasons for their success and also some changes that have occurred in the 1980s to affect these factors.

(1) **Market-oriented policies**--Their success has been largely the result of market-oriented, outward-looking policies. They allow the market to work and have a private-sector approach to economic development. Business activities are mainly left to the private sector and the allocation of resources is basically left to the market. Furthermore, in a number of Asian developing countries governments are actively promoting privatization of various sectors of their economies. Countries that tried to replace the market through direct controls have generally had inferior records of development. For the government to overrule or replace the market requires that governments have the knowledge, foresight and administrative capacity to undertake complex intervention. In practice, administrators are, however, often not able to accomplish these tasks. It is important that the government does not try to overextend itself and try to take over decision-making in areas best left to the market. The difficulties of planning and the misallocation and corruption resulting from numerous regulations and controls have been underestimated: and good effects have been overestimated.

The role of the government, however, is not limited to following the textbook laissez-faire model. The governments of the Asian developing countries have all (with the possible exception of Hong Kong) been a determining force in economic development. They have participated actively in selecting and implementing a growth strategy, and have, to varying degrees, selected priority industries. Government planning and regulation is still required. Nevertheless, under an outward-looking strategy the emphasis on direct controls is reduced; government decrees become less important. Rather, government policies are implemented primarily through indirect controls that work through the price mechanism.

Although strong government guidance has been used in the 1960s and 1970s by the NICs (except for Hong Kong) to guide economic development, some problems with this approach have become apparent. In the early stages of industrialization, it is not difficult to pick the winners. Textiles, clothing, and other labor-intensive manufactures are natural choices. The succcess the NICs had in exporting labor-intensive manufactured goods allowed them to import capital goods, technologies and material inputs needed to upgrade their industrial structures. However, picking the winners is far more difficult when sectors involved are high-technology, heavy industries. It is more difficult to anticipate changes in comparative advantage. Picking losers becomes costly. Both Korea and Singapore have made major mistakes. With rising labor costs at home and slower growth and protectionism abroad, the emphasis shifted to skill- and high-technology industries especially in Singapore, and more capital- and skill-intensive industries in Korea. As mentioned earlier, both Korea and Singapore have had to re-evaluate their efforts to restructure their economies.

Their market-oriented approach, however, has given them flexibility to adjust to changes in the international environment. One recent example of this flexibility is Singapore. In 1985, Singapore experienced negative growth for the first time in 15 years partly because of high wage policies and an attempt to move too quickly into high-technology industries. The government has recognized its mistakes and has taken immediate action including a two-year wage freeze and decreases in required employer contributions and taxes. I feel that Singapore will be able to recover quickly in a similar manner to Korea, which in the 1980s, was also able to adjust policies and in one year check the sharp fall and return to a high growth path.

The ASEAN countries provide numerous examples of the difficulties in using a "pick the winner" approach. Some examples include attempts to nurture the development of an aircraft industry by Indonesia and automotive industries in Malaysia and Thailand. These are examples of industries which will require costly subsidies for an extended period of time and may in fact never become competitive in a global context. It is important here to remember that flexibility to reverse policy direction has been an important factor in the success of the NICs.

(2) **Trade-orientation.** The Asian developing countries have been internationally oriented, welcoming foreign trade and investment. Trade has been an important component of the rapid growth of the Asian developing countries, growing between 20 and 30 percent in these countries in the 1970s (Table 2). In Table 7, you can see that exports make up a large proportion of the NICs total output (GNP), ranging from nearly 40 percent of Korea to more that 100 percent for Singapore. The 4 ASEAN countries are less trade oriented but still the trade-income ratios are large (21 to 58 percent).

With only a few exceptions, imports have been even larger than exports. As would be expected in countries experiencing rapid industrialization, imports of machinery and equipment have been especially important. Table 8 shows that despite the increasing shares of imports of mineral fuels due to the jump in oil prices in the 1970s, import shares of electrical and nonelectrical machinery continued to be high.

The Asian developing countries have all increased emphasis on exports for development. The timing of liberalization and the specific policies adopted vary from country to country. Hong Kong and Singapore have long been virtually free trade economies, while Korea and Taiwan substantially reduced tariffs and corrected exchange rate misalignments in the 1960s. The ASEAN-4 countries have not been as outward-looking as the NICs, because of a number of economic and political constraints. They have generally followed more restrictive trade policies, designed to foster industries producing for the domestic market. Generally in the 1970s, the ASEAN-4 countries moved toward more neutral policy stances, reducing distortions caused by import substitution policies. In other words, policy incentives for firms to produce for the domestic and external markets became more balanced.

Although the ASEAN-4 countries sought to diversify exports to reduce reliance on traditional raw material and agricultural commodities in the 1970s, the share of primary commodity exports in total exports remains high (Table 9). In particular, the share of mineral fuels increased from 69 percent in 1978 to 76 percent in 1983 for Indonesia, and from 14 percent to 29 percent for Malaysia. With the sharp decline in oil prices in 1986, it is expected that these ratios will have since declined, but they are indicative of the importance of mineral fuel exports in these two countries.

Therefore, the sharp and prolonged decline in the price of primary commodities meant declining export revenues in the 1980s for these countries. Oil prices dropped, leading to dampened prospects for growth in Indonesia, Malaysia, and Singapore. Non-oil commodity prices have also remained weak (Figure 1). The prices of tin, rice, palm oil, and rubber, all major export items of the region, have declined in the 1980s. This was because of increasing supply and decreasing demand for primary commodities. Short-term increases in supply due to good weather conditions and bountiful harvests have pushed down prices of agricultural and food products. Longer-term factors including increases in productivity due to improvements in technology, and better farm incentives in developing countries have also increased supplies. Several formerly large importers of food, such as China, India, and Indonesia, have achieved virtual self-sufficiency in food production. At the same time, farm subsidies and artificially high price supports in many of the advanced countries have contributed to surpluses. Demand for primary commodities decreased due to technological improvements, the movement toward miniaturization, and substitution to man-made materials. The shift toward higher technology- and service-oriented industries may indicate that these changes are part of a long-run trend toward lower demand for such commodities.

The ASEAN-4 countries have generally adopted austerity measures to solve current account deficits brought about by falling export revenues, declining factor payments from Middle East countries, and high debt servicing requirements. They have restricted public spending and imports, and as mentioned above, they have put limits on public borrowing. At a time of slow growth, such policies are likely to contribute to slower growth and bring about strains in the social and political fabric of these countries. Limiting imports directly constrains growth to the extent that capital equipment and industrial inputs are less available. Import cuts also have profoundly negative effects on consumer welfare and incentives of the work force, in general. In addition, domestic austerity programs increase the dependence of these countries on external demand for economic growth.

On the other hand, the drop in commodity prices is welcome news for the other NICs. The lower import costs and the indirect effect of probable increase in growth of OECD countries due to lower oil prices makes future prospects brighter. In addition, the aprreciation of the yen has increased the competitiveness of their manufactured exports in the Japanese market as well as in other third markets. Hong Kong and Taiwan had trade surpluses in 1985 which will probably continue in 1986, while Korea will probably emerge with a trade surplus in 1986.

The Asian developing countries will continue to rely on trade: they have very few options. I do not believe that domestic demand can be used to offset decreases in trade in these countries except in the short run. Singapore and Hong Kong have used public construction in the past to stir growth, but the limits to such policies are obvious. Some countries like Indonesia can use foreign reserves to cushion declining export receipts for a limited period but eventually will have to increase exports.

A long-run development strategy reflecting export pessimism is a mistake. It is easier to push import substitution with the excuse that world demand is poor than it is to search for new opportunities. The future should not be viewed in terms of simply dividing up a fixed amount of exports. Diversification of exports and markets will be important. Countries like Thailand and Malaysia achieved a great deal of diversification within primary products in addition to manufactured goods.

(3) **High saving and investment.** Another reason why these countries have done well is that they save and invest more. In order to grow, you have to invest in infrastructure, education, and capital formation. All this is expensive, and you must save. The countries that have done well have generated their own saving for domestic investment.

The NICs and ASEAN-4 countries have generally been very successful at mobilizing domestic resources. Savings-to-GDP ratios increased or remained at high levels through the 1970s, especially in the NICs (Table 10). By the 1980s, domestic saving averaged over 30 percent of GDP in the NICs, financing most of gross domestic investment. Some of the NICs have even emerged as capital-surplus countries.

The ASEAN-4 countries have also improved their savings and investment performance, though not as dramatically as the NICs. Thailand's saving and investment increased to more than 20 percent of GDP by the 1970s. In the Philippines, savings increased in the 1970s but dropped to 18 percent by 1984. Indonesia and Malaysia, achieved high saving ratios, though this was done with the aid of high earnings from oil exports that may be diminished in the future.

In several countries of the region, however, private savings rates have been falling. The situation is especially serious in Thailand and the Philippines where marginal savings rates have fallen, (Table 11) but also apparent in Indonesia, Korea, and Malaysia. Fiscal and financial reforms will be needed to revitalize private savings to enable them to finance a larger share of capital formation. A financial sector that provides consumers of financial services the greatest choice in terms of accessibility, variety of instruments with respect to size and maturity, while guaranteeing depositors a positive real rate of return is more likely to call forth additional savings.

(4) **Good Macroeconomic policies.** Price distortions in the Asian developing countries are relatively small as openness to world trade requires prices to correspond with changing conditions in the world economy.[2] Because the Asian developing countries have generally adopted prudent macroeconomic policies to control budget deficits and restrain excessive demand, inflation rates have been relatively low. Even those with serious bouts of inflation, managed to keep the average rate below that of other middle-income countries (Table 12).

The Asian developing countries will face many challenges in adjusting to the more difficult external environment of the 1980s. A number of policy reforms will be necessary to adjust to problems in the short and medium term, but it is important to maintain and even strengthen the long-run strategy of outward-looking development policies. Policies of the United States and Japan, however, will have a great impact on the ability of these countries to maintain such policies. The following sections will examine issues in trade and investment in the region.

IV. Trade Issues and Opportunities in the 1980s

Integration in the Region

Not long ago, only 3 percent of U.S. GNP was devoted to trade. Now the figure is closer to 10 percent. Much of this increase is due to the expanding trade with the Asia-Pacific region. In the last ten years,

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[2] A World Bank Study found that the relatively open developing Asian countries do indeed have a lower composite index of price distortions than developing countries in other regions. World Bank (1983). World Development Report, p. 63. The study also found a high negative correlation between price distortions and growth.

American trade with Japan rose from 11 to 17 percent, whereas trade with the EEC remained constant. Trade with the NICs and ASEAN-4 countries has grown even faster and is now comparable to that of Japan. Latin America has been the U.S.'s largest trading block among developing regions. This is not surprising due to the proximity of Latin America, but trade shares with the ASEAN-4 countries and the NICs increased from less than half that of the Latin American countries in 1970 to nearly comparable shares. Trade with the Asian developing countries will continue to grow rapidly because the countries will grow faster than other countries including Japan.

The rapid growth of the developing Asian countries has been supported by a complementary division of labor among the countries in the Asia-Pacific region. The United States and Japan have been important trade and investment partners of the NICs and ASEAN-4 countries. The United States, Japan, the NICs and ASEAN-4 countries are different in terms of factor endowments and levels of economic development. ASEAN-4 countries are resource rich, labor abundant and still developing; the NICs are resource poor and but nearly developed with a large skilled labor force; Japan is resource poor but is highly developed with scarce labor; and the United States is highly developed with a resource-rich economy.

When trade was expanding rapidly in the 1960s and 1970s, these differences contributed to a dynamic growth and changes in comparative advantage. Countries moved up the ladder of comparative advantage--beginning with specialization in primary products, moving to unskilled labor-intensive manufactures, skilled labor-intensive products, capital-intensive goods, and finally to knowledge-intensive goods. As one group of countries move up the ladder, another group can take their place. A large part of the NICs' exports replaced Japanese exports in the world market and did not depend only on increases in import demand. Malaysia and Thailand have begun to make their presence felt in the world market for textiles, clothing, and electronics, as the NICs move into more skill-intensive products.

With slower growth in trade in the 1980s, this process has become more difficult. Countries find it harder to move up the ladder. Structural adjustments become more painful, and pressures to protect declining industries grow.

The relatively open American market has been a major source of growth in demand for the NICs' exports. Half of Taiwan's exports and more than a third of Korea's and Hong Kong's are directed to the United States (Table 13). The United States also constituted a major market for exports of ASEAN-4 countries. Although the principal market for the ASEAN-4 countries is Japan, the bulk of Japanese imports from these countries consists of agricultural commodities and raw materials. A large share of the manufactured exports of these countries are directed to the United States. As these nations continue to diversify into manufactured exports, they will attempt to expand exports to the U.S. market. But access to the U.S. market may become more difficult.

Until recently, the United States served as a locomotive to world growth through rapidly expanding imports. The other developed market economies, on the other hand, were able to stimulate growth by expanding exports to satisfy U.S. demand rather than by raising domestic demand. But this has resulted in huge U.S trade deficits which are no longer sustainable, and increasing trade surpluses, especially in Japan and West Germany. The U.S. trade deficit is largely an internal problem caused by low saving, productivity declines, and large budget deficits. But the political movements to reduce budget deficits (Gramm-Rudman) and protect failing industries indicate that the situation is changing. Continuation of stimulus to world trade from the United States is not likely.

The inability of the United States to absorb the increasing flow of manufactures from these countries and Japan has become apparent in recent years. From 1982, the U.S. trade deficit nearly doubled every year (Table 14). The rate of growth of the large U.S. trade deficit has slowed but the absolute size remains large even after the sizable depreciation of the U.S. dollar.

Japan's share of the U.S. deficit declined from a peak of 45 percent of this deficit to account for about 30 percent in the mid 1980s and may decline even further in the late 1980s. The dollar, however, has not really weakened relative to the currencies of the Asian developing countries, Canada, or Latin America. In fact, as mentioned above, the appreciation of the yen has increased the competitiveness of the NICs' exports in the U.S. market vis-a-vis Japanese products. We would expect to see a shift in the direction of our imports away from Japan to these areas. Our trade deficit with the Asian developing countries is still small, except for Taiwan accounting for 7 percent of the whole. Furthermore, the share has been decreasing since 1982. It is interesting to note that the EEC now accounts for 15 percent of the U.S. deficit, after U.S. trade surpluses with this region in the early 1980s.

Although something must be done about the large U.S. trade deficit with the region, particularly with Japan, the United States needs to consider a coordinated approach that takes into account the structural features and development issues confronting the various Asian countries. Adoption of trade policies that undercut the long-term U.S. commitment to promote economic development along open, market-based lines could undo decades of painstaking and difficult developmental progress. The U.S. policy posture towards these countries can and should be adjusted in light of the above facts. Moreover, the United States and Japan need to consider the impact of their bilateral problems and policies on the other Asian nations.

Additionally, the United States should not forget the relatively low level of per capita income in the region and also the importance of the Asian developing countries as a large and growing market for U.S. exports and investment. In fact, as mentioned above, U.S. merchandise exports to these countries have been growing faster than total exports (Table 15); exports to these countries have risen to 11 percent of total exports and 11 percent of manufactured exports. This is comparable to Japan's share of U.S. total exports and much higher than Japan's share of manufactured exports. Manufactures accounted for an average of 65 percent of U.S. exports to the NICs and more than 75 percent to the ASEAN-4. In contrast, manufactures accounted for only 47 percent of U.S. exports to Japan. U.S. exports to the NICs and ASEAN-4 countries were largely concentrated in areas of our comparative advantage--machinery, chemicals, and other capital- and technology-intensive sectors. With the continued rapid growth of these countries, it can be expected that the demand for equipment and capital goods will continue to expand. The exchange rate realignment should further expand opportunities for expansion of U.S. trade in the region.

Opportunities for Increased Trade in the Region

(1) The U.S. faces difficult macroeconomic problems--a low rate of

domestic savings, large federal budget deficits, and a continued large gap between imports and exports. More fundamentally, a substantial portion of U.S. industry is undergoing painful structural change as a result of increased foreign competition and declining competitive strength. However, the U.S. also has leadership in a number of areas and continued dynamism in a broad range of industries, services and natural-resource-based activities. Policies are needed to facilitate structural change rather than obstruct it. Hopefully, the U.S. will promote policies that enhance the smooth adjustment of the economy's structure rather than resorting to policies which protect declining industries.

(2) The large depreciation in the U.S. dollar automatically increased the competitiveness of U.S. goods; U.S. firms did not have to do anything. But the effect of depreciation is only temporary unless major structural changes are made to maintain competitiveness. If the inflationary tendency coming from increased import prices is allowed to manifest itself, the price benefit of the depreciation will be lost.

Therefore, U.S. firms must also make a concerted effort to maintain competitiveness. We cannot expect the exchange rate adjustments to restore all of the U.S. competitiveness. The huge technology edge enjoyed by America in the 1950s and 1960s has disappeared. The United States once had effortless economic superiority, but now it is faced by many competitors. From 1977-1983, the productivity of the American manufacturing sector grew 1.2 percent annually. This is only 1/2 of that of Germany (2.5 percent), and 1/3 of those of France (3.5 percent) and Japan (3.9 percent). The current position of the U.S. is not one of inferiority, but if such differences in growth rates continue, the U.S. may fall further behind. The solution to U.S. trade problems is related to how well we do in the

Asian developing countries. The U.S. economy will suffer if American firms in areas of U.S. comparative advantage--namely, high-technology and capital-intensive goods and in various service industries--do not accept the challenge.

U.S. firms will not only have to decrease relative production costs but also increase their understanding of foreign markets. Until a few years ago, little attempt had been made by the large majority of U.S. firms in this regard, primarily because of the large domestic market. American goods have traditionally been bought not sold; in the increasingly competitive global market, this complacent attitude is untenable. In contrast, Japanese manufacturers and trading companies (with the some help of the Japanese government) do extensive market analyses and produce goods suited to the tastes of the intended consumer.

(3) For U.S. firms to increase their commitment to increasing export competitiveness, however, the government must be committed to this goal as well. The American business community is not likely to embark on new ventures in trade-oriented fields if it feels that the government will reverse its policies in the near future.

(4) At the same time, Japan must make a greater effort to increase imports not only from the United States but also from the Asian developing countries. Manufactured imports make up only 20 percent of total Japanese imports. The comparative figure for the United States is about 50 percent. Even the highly competitive manufactured exports of the NICs have, until recently, not been very successful at penetrating the Japanese market. Japan must proceed with structural changes necessary to sustain Japan's growth and to facilitate the changes in comparative advantage occurring throughout the region as called for in the so-called Maekawa report.

(5) There is also a need for further import liberalization by the Asian developing countries, particularly Korea and Taiwan. Although all of these countries have moved toward export-promotion policies, they have maintained restrictions on imports. Export promotion, particularly in the ASEAN-4 countries, was superimposed over import-substitution policies.

Although the United States has traditionally accepted relative inequality in terms of market access, the growing trade deficits and the increasing level of development of these countries make it imperative that more reciprocal market opportunities exist. As the exports of these countries begin tc challenge those of many developed countries, the Asian developing countries must accept the responsibilities of maintaining an open international economy. Several of these countries have reduced trade barriers under IMF and World Bank direction and U.S. pressure. Korea, for example, has begun to open its service sector. The speed of the liberalization process should, however, be increased. It is hoped that these countries will also participate more directly in GATT negotiations.

The United States has also pushed Korea and Taiwan to revalue their currencies *vis-a-vis* the U.S. dollar. However, it should push for further trade liberalization instead, as increased imports resulting from lowering trade barriers will push the value of the currencies down.

(6) Finally, a large number of U.S. firms have subsidiaries and affiliates in these countries. There is an interaction between trade and direct foreign investment; trade and investment cannot be looked at in isolation. For example, U.S. multinational companies account for a large portion of U.S. international trade. According to the 1982 survey by the U.S. Department of Commerce, exports to U.S. affiliates abroad accounted for 27 percent of total U.S. merchandise exports, while imports from those

affiliates comprised 20 percent of U.S. imports.[3] In other words, the contribution to trade by the U.S. affiliates is significant, and they generated more exports than imports. For U.S. exports of services, the interrelationship is even more apparent. It is difficult to sell services without setting up an affiliate abroad.

V. Direct Foreign Investment

It is important, therefore, to also look at the opportunities for investment in the region. The rapid growth in the region expands not only opportunities for trade but also for investment. There are several indications that the opportunities for investment in the region will increase.

(1) Despite the fact that savings rates are high in these countries, investment rates have been higher and external flows have been used to fill the gap. In fact, external financial flows into these countries increased more than 4 times in the past decade. Table 16 shows that there have been shifts from official to private flows in the NICs and the ASEAN-4. The share of private flows nearly doubled over the decade; private flows now account for nearly 80 percent of the total flows to the NICs and 44 percent to the ASEAN-4 countries. The NICs' higher level of development has reduced their need for official assistance and has increased their attractiveness to foreign investors. In the ASEAN-4 countries and Korea, the shift to private sources is correlated to increasing levels of external debt.

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[3] United States, Department of Commerce, Bureau of Economic Analysis (1985). U.S. Direct Investment Abroad: 1982 Benchmark Survey Data, Washington, D.C.

Recently, external capital inflows, even private flows, have slowed. The slowdown in capital flows is largely a result of the debt problems encountered by developing countries worldwide in the early 1980s. The emergence of such problems have made international bankers and investors more wary of committing funds to developing countries and also made developing countries more averse to borrowing in the international market. Although it is impossible to determine whether supply or demand factors have been more important in Asia, casual observation suggests that Asian countries (other than the Philippines) have had relatively little trouble in borrowing from foreign sources. Thus, demand-side factors, especially those related to austerity policies brought on by the desire to minimize foreign debt, appear more important.

Several countries experienced a dramatic increase in their external debt servicing ratios in the early 1980s (Table 17). Fortunately, to date the debt problem has been a major constraint only in the Philippines and the causes of the Philippine problems had very deep political roots. Nonetheless, total debt and debt-service-to-export ratios are also high in the other ASEAN-4 countries. There is the potential for severe debt problems to emerge in several Asian countries if the need to borrow abroad increases sharply as a result of a rise in interest rates, a prolonged contraction or stagnation of world trade, and/or a prolonged fall in domestic savings rates.

This presents a challenge for the Asian developing countries to further increase domestic saving as well as to attract non-debt creating flows, especially direct foreign investment. Most of the Asian countries have implemented policies to encourage foreign investment.

(2) The tone of discussion concerning DFI has changed considerably in

the last few years. In the past it was very common to hear multinationals being accused of exploiting developing countries and being responsible for a host of economic evils. Now the focus has shifted to discussion of 1) how multinationals can be encouraged to invest and 2) how they can then be encouraged to positively contribute to the host country.

(3) It is often believed that foreign direct investment dominates total investment in Asian developing countries, but the contribution of foreign investment is actually small. Significantly, the ratios of DFI to gross investment are well under 5 percent (Table 18). The major exceptions are Singapore and Hong Kong with DFI being particularly large in the former, and a share in excess of 10 percent for Malaysia.[4] This implies that there is ample room for growth without negative repercussions.

(4) Yet, foreign firms have been more important than the DFI/GDCF ratios might suggest for several countries. DFI can be an important catalyst to industrial development. Manufacturing sector DFI has clearly played this role in the NICs and a similar role appears to be evolving in Malaysia and Thailand as well. Moreover, the role of U.S. petroleum investment has been very significant in Indonesia, Malaysia, and Thailand, and service sector DFI has played an important role in building the social infrastructures of these countries.

In addition, foreign firms often account for a much larger share of trade flows. Korean and Taiwan data sources show, for example, that trade carried out by foreign firms account for as much as 34 percent of Korea's total trade flows and 29 percent of Taiwan's total trade flows, while wholly foreign establishments accounted for 66-72 percent of Singapore's domestic exports.[5] Second, although the value added of foreign firms in Korea and Taiwan is a small portion of total GNP, value added of foreign manufacturing firms makes up a larger portion of manufacturing output. These facts suggest that foreign firm activity has a large impact on the trade and manufacturing sectors of the host economies, despite relatively low levels of DFI.

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[4] These ratios are significantly different for Singapore (8.6 percent) and Malaysia (1.3 percent) when OECD data are used. For Malaysia, this may be explained by the more limited coverage of the OECD data; DFI from Singapore is not included. The reasons for the discrepancy for Singapore is unknown. DFI from OECD, Geographical Distribution of Financial Flows to Developing Countries, various issues.

Investment Patterns in the Region

Direct foreign investment flows into the Asian countries come from many sources, namely, the United States, Japan, the European Economic community (EEC) countries, as well as other Asian countries. The United States and Japan are the most important sources; together they account for more than half of the total direct investment inflows. Although Japanese investment was concentrated in Asian developing countries in the 1970s, growth of Japanese investment in the region has slowed in the 1980s. The focus of Japanese investment has shifted toward the United States, which is now the largest recipient of Japanese DFI. The yen realignment, however, is likely to redirect Japanese investment toward Asian developing countries to take advantage of the cheaper, skilled labor force as Japanese firms lose some of their competitiveness in domestic production.

In contrast, the United States has steadily increased its DFI in Asian developing countries. In the 1966-1977 period, U.S. investment in Japan grew rapidly but investment in the Asian developing countries has grown more quickly since. Presently, nearly 4 percent of U.S. DFI is in Japan and more than 6 percent is in the NICs and ASEAN-4 countries (Table 19). Indonesia has emerged as the leading recipient of this, accounting for nearly 2 percent of the total U.S. DFI position. Hong Kong and Singapore each account for about 1 percent, while investment in Korea, Taiwan, Malaysia, and Thailand has been on a smaller scale but has also grown steadily. The Philippines, however, has seen its share decline.

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[5] S. Naya, V. Vichit-Vadakan, and U. Kerdpibule, ed. (forthcoming). Direct Foreign Investment and Export Promotion: Policies and Experiences in Asia. East-West Resource Systems Institute and Southeast Asian Central Banks Research and Training Centre: Honolulu, Hawaii and Kuala Lumpur, Malaysia.

There are substantial differences in the sectoral patterns of DFI depending on the host countries (Table 20). In the ASEAN-4, U.S. investment has been concentrated in the petroleum sector. Petroleum investments have also been significant in Japan, Hong Kong and Singapore; indeed Japan, the NICs and the ASEAN-4 countries combined to account for 14 percent of the world wide U.S. FDI in petroleum. In the NICs, manufacturing investment has been more important, and in Malaysia and the Philippines nearly 50 percent of the U.S. investment is in manufacturing. In particular, investment in electric and electronic equipment has been extremely important, comprising 16 percent of the U.S. investment in this sector and 25 percent of DFI income in this sector.

Thus, although U.S. investment in the NICs and ASEAN-4 countries accounts for just over 6 percent of the total U.S. position, it has been significant in several sectors, particularly petroleum and the manufacture of electrical and electronic equipment. It is significant to note the importance of U.S. trade with the region in these sectors. Furthermore, this investment appears even more important when analyzing DFI income figures (Table 21). DFI income in the NICs and ASEAN-4 countries accounted for about 17 percent of the total in the early 1980s but fell under 10 percent in 1985. Thus, the shares of DFI income have greatly exceeded shares of DFI stock; in other words, the rate of return is higher on DFI in Asian developing countries than on DFI in the rest of the world.

Growth of U.S. investment in the NICs and ASEAN-4 countries has been faster than the average U.S. investment for all developing countries, especially in manufacturing and trade industries. However, it could have grown even faster given the rapid growth of the region. Generally, Japan has outcompeted American firms in terms of investment in Asian developing countries. This is partly explained by the nature of Japanese investment. Japanese investment tends to be in the preferred (usually labor-intensive or exporting) sectors and with host country partners. American investment, on the other hand, tends to be in high-technology or resource industries which are not conducive to partnerships. Hence, U.S. firms tend to prefer wholly-owned subsidiaries, which do not fall necessarily under incentives given by the host government. Japanese firms, therefore, are more often able to take advantage of incentives offered by the governments of these countries.

Many small- and medium-sized Japanese firms have been very successful in both trade and investment, despite the high information costs and risks involved in such ventures. A major reason for the success of these small firms is the involvement of trading companies. The Japanese trading company is able to link supply and demand, provide financing, market information, and management skills. U.S. antitrust laws prohibit American firms from providing such a complete package; reexamination of such policies may be in order to enhance U.S. competitiveness in trade and investment. We seem to be moving in this direction with the enactment of the Export Trading Company Act of 1982. The goal of this Act is to increase U.S. exports by removing some of these antitrust disincentives to export activities.

VI. Conclusion--Future Prospects

Although the growth rates of the Asian developing countries have slowed in the 1980s, it will not stay down for long. The dynamism and market orientation of these countries will continue to provide tremendous trade and investment opportunities in a wide variety of areas. It is important for the United States to participate, rather than retreat from the increasing interdependence in the region. American businesses need to reach out and actively take advantage of trade and investment opportunities in Asia.

The commercial policies of the United States, as well as Japan, have a significant effect on the region. Failure to achieve market-opening by Japan could lead to wide-ranging U.S. restrictions which would negatively affect Asian developing countries. But a protectionist approach will not provide a long-run solution to U.S. trade problems. We will not stop the declines in U.S. productivity by protecting our declining industries. Instead, we must concentrate on industries where we have a comparative advantage to regain our competitiveness. The U.S. has much to gain from increasing interdependence with the world economy. A more outward-looking approach by the U.S. government and businesses is essential for healthy U.S. economic growth in the future.

Table 1
Average Annual Rates of Growth of Real
GDP and GNP Per Capita

	Average Annual Rates of Growth (%)			
	Real GDP			GNP Per Capita
	1960-70	1970-80	1980-85*	1965-84
NICs				
Hong Kong	10.0	9.0	6.7	6.2
Korea	8.8	8.6	5.3	6.6
Singapore	9.6a	9.6	6.8	7.8
Taiwan	9.3	9.8	6.3	7.0
ASEAN				
Indonesia	3.9	7.9	5.5	4.9
Malaysia	6.5	7.8	6.2	4.5
Philippines	4.8	6.0	0.5	2.6
Thailand	8.1	6.9	5.4	4.2
World	5.0a	3.7	2.3	
Industrialized countries	4.8	3.2	2.1	
United States	3.8	2.8	2.2	
Japan	11.5	5.4	4.2	
Developing countries	5.7a	5.6	2.9	
Africa	4.3	4.2	1.7	
Middle East	7.9a	6.6	1.6	
Latin America[c]	5.1	4.9	1.1	
Asia[b]	6.1	6.5	5.2	

*1985 preliminary estimates.

[a] 1961-70.
[b] Bangladesh, Burma, Hong Kong, India, Indonesia, Malaysia, Nepal, Pakistan, Philippines, Singapore, South Korea, Sri Lanka, Taiwan, Thailand.
[c] Excluded countries in the Western Hemisphere with population of less than one million.

Sources: International Monetary Fund, *International Financial Statistics*, Yearbook 1985, June 1986.
World Bank, *World Development Report*, 1986 and 1984.
Asian Development Bank, *ADB Annual Report*, 1985.
Republic of China Council for Economic Planning and Development, *Taiwan Statistical Data Book*, 1985.

Table 2
Growth of Exports[a]
(in percent)

	1960-70	1970-80	1980-85	1981	1982	1983	1984	1985	1985 (F.O.B.; US$ billio
NICs									
Hong Kong	14.5	22.8	12.9	10.5	-3.8	4.6	29.0	6.9	30.18
Korea, Rep. of	40.9	37.1	12.2	21.4	2.8	11.9	19.6	1.1	29.56
Singapore	3.5	27.6	8.9	8.2	-0.9	5.0	10.3	-5.2	22.81
Taiwan	23.4	31.7	11.8	14.1	-1.8	13.2	21.2	0.9	30.72
ASEAN-4									
Indonesia	2.2	38.3	4.3	1.6	0.2	-5.1	3.6	-15.1	18.5
Malaysia	4.8	22.9	6.3	-9.1	2.2	17.2	16.9	-6.3	15.4
Philippines	7.3	20.9	0.9	-1.5	-12.2	-1.6	7.9	-12.7	4.6
Thailand	6.8	23.7	5.6	8.1	-1.2	-8.3	16.4	-4.0	7.1
World	9.5	20.8	2.9	-1.7	-7.3	-2.9	5.8	1.1	1,782.9
Industrialized Countries	10.5	18.9	3.3	-1.7	-5.2	-1.4	6.6	3.6	1,258.5
U.S.	8.6	18.0	3.2	5.9	-9.2	-5.5	8.7	-2.2	213.1
Japan	17.1	21.6	10.2	16.1	-8.7	6.2	15.5	4.4	177.1
Developing Countries	6.5	26.4	1.8	-2.2	-11.7	-6.9	3.4	-4.8	493.7

[a] Average annual rates of growth based on current prices.
[b] 1973-80.
[c] 1964-70.

Sources: IMF, *International Financial Statistics*, Yearbook 1986, October 1986.
Republic of China Council for Economic Planning and Development, *Taiwan Statist Data Book*, 1985.
Department of Statistics, Ministry of Finance, *Monthly Statistics of Exports Imports, The Republic of China (Taiwan District)*, February 20, 1986.

Table 3
Real Growth Rate of World Trade
1968–1985[a]
(Average annual change in volume; in percent)

Average	1968–77[b]	1978	1979	1980	1981	1982	1983	1984	1985
World Trade[c]	7.7	5.4	6.5	1.7	0.8	-2.3	2.8	8.7	2.9
Exports									
Industrial Countries	8.1	5.5	7.0	4.1	3.6	-2.2	2.5	9.3	3.9
Developing Countries	5.7	4.0	5.0	-4.0	-5.7	-8.1	2.9	7.1	0.4
Fuel Exporters	4.7	-1.6	1.7	-13.1	-15.1	-16.5	-3.7	0.7	-4.1
Non-fuel Exporters	7.1	9.4	8.4	9.1	6.5	0.7	8.3	11.7	3.4
Imports									
Industrial Countries	7.4	5.6	8.8	-0.7	-1.5	0.1	5.1	13.0	5.2
Developing Countries	9.2	7.1	4.8	8.5	7.1	-4.2	-3.2	2.2	-0.3
Fuel Exporters	16.7	3.9	-4.3	13.3	20.0	-1.6	-12.0	-4.5	-8.8
Non-fuel Exporters	6.6	8.9	9.3	6.5	1.5	-5.5	1.6	5.2	3.3

[a] Excluding China prior to 1978.

[b] Compound annual rates of change.

[c] Averages based on data for the two groups of countries shown separately below and on partly estimated data for the U.S.S.R and other nonmember countries of Eastern Europe and, for years prior to 1978, China.

Sources: IMF, World Economic Outlook, April 1986.

Table 4
Size of Asian Countries in 1984

Countries	Population (millions) mid-1984 (1)	Area (Thousands of square kilometer) (2)	GDP ($ million) (3)	GDP Per Capita* (US$) (4)
NICs				
Hong Kong	5.4	1	30,620	6,330
Korea	40.5	98	83,220	2,110
Singapore	2.5	1	18,220	7,260
Taiwan	18.8	36	57,340	3,050
ASEAN				
Indonesia	161.5	1,919	80,590	540
Malaysia	15.3	330	29,280	1,980
Philippines	53.3	300	32,840	660
Thailand	50.7	514	41,960	860
United States	236.7	9,363	3,634,600	15,390
Japan	120.0	372	1,255,006	10,630

*World Bank Atlas Methodology, 1982-84 base period, rounded to the nearest ten.

Sources: World Bank, World Development Report, 1986.
ADB, Key Indicators of DMCs of ADB, supplement, Oct. 1985 country tables, April 1985.

Table 5: Structure of GDP in the NICs, the ASEAN-4, Japan, and the U.S. (percent of GDP at current prices)

Group/ Country	1970				1978				1985			
	Agri.	Manuf.	Other Ind.[a]	Serv.	Agri.	Manuf.	Other Ind.[a]	Serv.	Agri.	Manuf.	Other Ind.[a]	Serv.
NICs												
Hong Kong[b]	2.0	30.9	6.3	60.8	1.1	24.3	7.9	66.6	0.5	24.6	7.6	67.2
Korea	26.9	20.9	8.6	43.6	20.2	27.8	10.4	41.6	13.8	28.1	12.7	45.4
Singapore	2.3	20.4	9.7	67.5	1.5	26.0	8.5	63.9	0.8	24.0	13.9	61.3
Taiwan	15.6	33.5	7.8	43.2	9.5	41.9	9.7	38.9	6.0	40.7	9.0	44.3
ASEAN-4												
Indonesia[b]	47.2	9.3	8.6	34.9	29.5	10.6	25.1	34.7	24.9	12.0	24.2	38.8
Malaysia[c]	29.6	14.3	12.4	43.7	25.2	18.3	11.1	45.4	19.5	20.5	16.6	43.3
Philippines	27.6	22.6	7.1	42.7	26.7	24.6	9.9	38.8	26.5	24.7	8.0	40.8
Thailand	28.3	16.0	9.3	46.4	27.5	19.0	8.6	44.9	17.4	19.8	10.0	52.8
Japan[b]	6.1	35.9	10.7	47.3	4.6	29.6	12.1	53.7	3.2	29.8	11.1	56.0
U.S.[d]	2.7	25.7	9.2	62.4	2.9	24.4	9.9	63.0	2.0	21.1	10.6	66.3

[a] Includes construction, utilities, and mining.
[b] Data reported is for 1984 instead of 1985.
[c] Data in constant 1970 or 1978 prices. Data reported is for 1971 instead of 1970.
[d] Data reported is for 1983 instead of 1985.

Sources: Asian Development Bank, Key Indicators of Developing Member Countries, Vol. 15 (April, 1984), Vol. 16 (April, 1985), Vol. 17 (July, 1986).
OECD, National Accounts Statistics, 1963-1980 (pub. 1982), 1972-1984 (pub. 1986).

Table 6: The Structure of Employment
(percent of total employed)

Group/ Country	1970				1978				1985			
	Agri.	Manuf.	Mining	Other	Agri.	Manuf.	Mining	Other	Agri.	Manuf.	Mining	Other
NICs												
Hong Kong[a]	1.9	35.4	na	62.7	1.4	43.3	na	55.8	1.6	36.2	na	62.2
Korea	50.5	13.2	1.1	35.2	38.4	22.4	0.8	38.4	24.9	23.4	1.0	50.6
Singapore	3.4	22.0	0.3	74.4	1.9	28.8	0.1	69.2	0.7	25.9	0.2	73.2
Taiwan	35.4	20.4	1.6	42.7	24.9	30.5	0.8	43.7	17.5	33.5	0.5	48.6
ASEAN-4												
Indonesia[b]	61.6	8.4	na	30.1	60.9	7.5	na	31.6	54.7	10.4	0.7	34.1
Malaysia	53.2	9.0	2.6	35.2	43.3	14.6	1.8	40.3	35.5	15.7	1.1	47.6
Philippines	53.8	11.9	na	34.3	52.8	11.5	na	35.7	49.3	9.7	0.7	40.4
Thailand	72.2	7.7	0.7	19.4	73.7	6.8	0.1	19.4	69.1	7.3	0.2	23.4
Japan	17.4	27.0	0.4	55.2	11.7	24.5	0.3	63.5	8.9	24.9	0.1	66.0
U.S.[c]	4.4	24.7	0.7	70.1	3.7	22.8	0.9	72.6	3.3	20.0	0.9	75.8

[a] Data refers to 1971, 1979, and 1985.
[b] Data refers to 1976, 1978, and 1982.
[c] 1971 data.
na = not available, included in Other.

Sources: Asian Development Bank, *Key Indicators of Developing Member Countries*, Vol. 17 (July 1986), Vol. 16 (April 1985), Vol. 15 (April 1984), and Vol. 14 (April 1983).
International Labour Organization, *Yearbook of Labour Statistics, 1985, 1981*.

Table 7
Asian Less Developed Countries, U.S. and Japan: Ratios of Exports and Imports of Goods and Services to GNP

	Exports		Imports	
	1970-71	1983-84	1970-71	1983-84
NICs				
Hong Kong	68.9[a]	83.5[a]	80.5[a]	87.2[a]
Korea, Rep. of	14.7	37.9	24.7	38.1
Singapore	80.3[b]	135.4[b]	127.8[b]	164.2[b]
Taiwan	32.6	55.6	31.3	45.0
ASEAN-4				
Indonesia	13.9	29.0	16.5	27.6
Malaysia	44.3	58.4	42.5	60.5
Philippines	19.0	21.0	19.6	24.2
Thailand	17.0	24.1	21.0	27.9
United States	5.3	7.5	5.6	9.9
Japan	11.8	16.5	10.0	14.0

[a] Value of merchandise goods as percent of GDP.
[b] Value of merchandise goods only.

Sources: ADB, _Key Indicators of DMCs of ADB_, 1984 and Supplement October 1985.
IMF, _International Financial Statistics_, Yearbook 1985 and May 1986.
World Bank, _World Tables_, 1983.

Table 8: Imports by Principal Commodity: 1970, 1978, 1983 (as percent of total commodities)

		Raw Mat.	Petro-leum	Agr. & Food	Chemi-cals	Res.Base Mfg.	Tex-tiles	Non-El. Mach.	Elec. Mach.	Cloth-ing	Trans. Equip.	Misc. Mfg.	Manuf. Goods	Total	Total (US$ mn)
NICs	1970	25.2	7.0	17.4	7.7	5.0	10.8	10.8	7.9	0.8	5.7	2.9	56.8	100.0	8,873
	1978	32.8	15.5	10.8	7.9	5.2	5.9	12.3	10.0	0.8	5.9	2.2	56.0	100.0	52,504
	1983	35.6	23.1	9.4	7.9	4.2	5.4	10.1	11.2	1.5	5.2	2.8	54.4	100.0	96,518
Hong Kong	1970	14.6	2.9	19.7	8.2	10.6	17.1	5.5	8.6	1.6	2.4	4.7	65.5	100.0	2,905
	1978	15.4	5.0	15.0	7.1	12.5	13.8	7.5	9.4	2.1	2.8	3.8	69.1	100.0	13,455
	1983	14.8	6.6	12.6	7.4	8.0	13.7	6.8	12.9	4.8	2.7	4.9	72.2	100.0	24,027
Korea[a]	1970	32.5	6.9	17.2	8.3	1.0	6.4	15.4	6.7	0.0	7.6	1.1	50.2	100.0	1,981
	1978	40.3	16.4	7.8	8.6	2.3	2.7	18.3	7.9	0.0	7.2	0.9	51.8	100.0	14,972
	1983	49.0	31.4	7.8	8.5	2.4	2.1	11.2	7.8	0.0	5.8	0.9	47.8	100.0	24,251
Singapore	1970	29.5	13.5	16.4	5.2	3.9	10.8	11.2	6.5	0.9	5.1	3.3	52.0	100.0	2,461
	1978	36.7	23.9	10.0	5.4	3.7	4.7	10.3	12.1	0.9	6.6	2.6	52.1	100.0	11,049
	1983	39.6	31.3	7.8	5.0	3.9	3.4	11.1	12.8	1.0	6.4	2.1	51.5	100.0	28,158
Taiwan[b]	1970	28.7	4.5	14.6	10.1	1.2	4.7	14.2	10.2	0.0	10.6	1.5	56.4	100.0	1,524
	1978	39.0	17.2	10.5	10.8	2.0	1.8	12.1	10.8	0.1	7.2	1.4	50.1	100.0	11,028
	1983	38.7	21.5	9.6	11.9	2.4	2.0	11.2	11.1	0.0	5.6	1.7	51.5	100.0	20,101
ASEAN-4	1970	23.5	9.2	13.6	10.9	4.8	5.8	16.1	5.9	0.4	10.7	1.9	61.1	100.0	4,885
	1978	28.3	14.9	12.0	11.2	3.2	2.5	15.0	8.2	0.1	9.8	1.4	56.1	100.0	23,050
	1983	34.1	22.7	8.3	10.6	3.0	1.8	16.2	8.9	0.1	7.4	1.1	53.9	100.0	47,302
Indonesia	1970	13.5	1.6	14.7	12.8	6.6	11.8	16.8	5.9	0.0	11.6	1.8	71.5	100.0	892
	1978	22.0	8.8	17.6	11.4	3.4	2.8	16.1	8.7	0.0	11.8	1.1	60.0	100.0	6,655
	1983	36.6	25.4	7.7	11.7	2.6	0.9	20.6	5.4	0.0	8.8	0.6	55.3	100.0	16,352
Malaysia[a]	1970	24.0	11.9	22.1	7.4	4.6	4.8	11.6	4.4	1.1	11.0	2.2	51.8	100.0	1,489
	1978	22.6	10.8	16.2	8.9	3.7	3.1	13.7	12.8	0.4	9.9	2.0	60.0	100.0	5,897
	1983	26.1	15.2	11.5	7.4	3.5	2.3	14.3	16.6	0.3	8.9	1.9	61.4	100.0	12,400
Philippines[a]	1970	30.7	12.0	11.2	11.5	4.3	2.1	20.0	5.4	0.0	10.0	1.1	57.7	100.0	1,210
	1978	34.2	21.2	7.9	11.2	2.7	1.8	15.1	4.2	0.0	8.1	1.0	48.1	100.0	5,143
	1983	36.2	26.5	10.1	10.1	2.3	1.9	12.7	4.9	0.0	3.9	0.9	40.7	100.0	8,263
Thailand	1970	22.9	0.7	5.2	12.9	4.2	6.4	17.0	8.1	0.4	10.4	2.4	67.8	100.0	1,293
	1978	36.9	21.1	4.2	13.6	3.1	2.2	14.9	6.4	0.0	8.9	1.3	54.5	100.0	5,356
	1983	38.2	24.3	4.1	12.9	3.6	2.5	14.1	8.4	0.0	6.3	1.2	53.5	100.0	10,287
Japan	1970	59.2	20.7	16.9	5.3	1.7	1.2	6.7	2.5	0.5	2.2	1.7	23.4	100.0	18,883
	1978	60.7	39.5	16.7	4.5	1.6	2.0	3.1	1.8	1.6	1.9	1.5	21.0	100.0	79,343
	1983	64.1	46.8	13.3	5.5	1.3	1.2	2.9	2.0	1.2	2.0	1.2	20.4	100.0	126,393
United States	1970	25.2	7.7	16.0	3.6	7.0	2.8	7.6	5.7	3.2	14.7	5.0	55.6	100.0	39,952
	1978	37.1	24.4	9.5	3.6	5.4	1.3	7.5	6.5	3.3	13.5	3.6	51.1	100.0	183,093
	1983	31.7	22.3	7.6	4.2	4.9	1.2	8.9	9.1	3.9	15.0	4.0	57.7	100.0	269,859

[a] 1982 is latest year available.

[b] Taiwan's electrical machinery for 1970 includes office machines and automatic data processing equipment. 1985 is the lastest year available for Taiwan.

Sources: United Nations, Yearbook of International Trade Statistics, 1972-73, 1981, 1982, 1983.
Department of Statistics, Ministry of Finance, Monthly Statistics of Exports and Imports, The Republic of China (Taiwan District), February 20,1986.

Table 9: Exports by Principal Commodity: 1970, 1978, 1983 (as percent of total commodities)

		Raw Mat.	Petro-leum	Agr. & Food	Chemi-cals	Res.Base Mfg.	Tex-tiles	Non-El. Mach.	Elec. Mach.	Cloth-ing	Trans. Equip.	Misc. Mfg.	Manuf. Goods	Total	Total (US$ mn)
NICs	1970	18.8	6.3	11.4	2.9	6.7	9.6	2.5	8.0	18.1	1.3	14.4	68.9	100.0	6,384
	1978	14.7	6.9	7.8	2.9	6.2	8.5	4.0	13.1	17.2	4.3	9.9	77.0	100.0	47,015
	1983	14.4	7.4	5.3	3.3	4.3	7.5	7.0	14.4	13.6	6.2	10.1	78.3	100.0	96,372
Hong Kong	1970	3.7	0.3	3.7	4.0	5.6	10.9	1.5	9.2	27.8	0.7	24.6	92.2	100.0	2,514
	1978	3.7	0.4	3.2	3.6	4.4	8.7	4.4	10.9	30.0	0.7	16.2	92.3	100.0	11,499
	1983	5.0	0.5	3.9	3.7	2.7	9.3	6.4	14.8	24.2	1.6	14.6	90.4	100.0	21,960
Korea[a]	1970	15.3	1.0	8.6	1.4	12.5	10.2	1.0	5.3	25.6	1.1	14.0	75.1	100.0	835
	1978	7.7	0.3	8.3	2.6	8.7	12.2	1.7	10.8	20.3	8.9	7.0	83.8	100.0	12,695
	1983	11.9	1.4	5.5	3.1	5.6	10.3	2.2	10.4	17.3	15.4	5.7	87.1	100.0	21,853
Singapore	1970	53.9	23.2	16.4	2.7	3.0	3.5	4.0	4.0	2.0	3.0	1.9	26.7	100.0	1,554
	1978	46.4	28.3	9.1	3.8	2.7	2.6	5.7	15.5	2.9	3.7	2.0	43.0	100.0	10,134
	1983	38.0	28.1	6.2	4.2	2.3	1.8	9.8	16.9	2.2	5.0	2.1	48.1	100.0	21,811
Taiwan[b]	1970	9.6	1.8	20.3	2.3	9.2	13.3	3.3	11.9	14.3	0.8	10.4	70.0	100.0	1,481
	1978	6.3	2.1	10.2	1.9	8.1	9.2	4.7	15.3	13.8	3.3	13.4	81.4	100.0	12,686
	1983	6.0	1.8	5.6	2.5	6.1	8.2	8.6	15.3	11.4	3.8	15.7	88.1	100.0	30,726
ASEAN-4	1970	65.4	10.9	27.7	0.7	2.4	0.5	0.4	0.2	0.2	0.3	0.3	5.7	100.0	4,589
	1978	62.7	34.1	23.0	0.7	2.1	1.5	0.1	3.2	1.6	0.3	0.8	11.9	100.0	26,542
	1983	61.8	44.1	18.1	0.8	3.4	1.4	0.5	4.8	2.3	0.2	0.8	16.1	100.0	44,566
Indonesia	1970	79.0	32.8	19.6	0.5	0.0	0.0	0.3	0.0	0.0	0.0	0.0	1.1	100.0	1,055
	1978	87.3	68.6	10.8	0.5	0.2	0.1	0.0	0.3	0.1	0.0	0.0	1.7	100.0	11,643
	1983	86.3	76.4	5.9	0.6	3.5	0.6	0.0	0.6	0.7	0.0	0.0	6.5	100.0	21,146
Malaysia[a]	1970	77.3	7.4	13.5	1.1	2.7	0.4	0.9	0.4	0.5	0.8	0.4	8.2	100.0	1,764
	1978	63.2	14.0	17.4	0.6	2.6	1.3	0.5	9.0	1.2	0.6	0.5	18.8	100.0	7,388
	1983	61.0	28.7	15.7	0.8	1.8	1.3	1.4	13.2	1.4	0.6	0.6	22.9	100.0	12,031
Philippines[a]	1970	49.5	1.6	44.0	0.5	4.4	0.5	0.0	0.0	0.0	0.0	0.4	6.3	100.0	1,060
	1978	24.6	0.3	42.9	1.8	5.0	1.3	0.0	0.9	4.7	0.6	2.4	20.0	100.0	3,425
	1983	18.4	0.7	32.7	1.9	3.5	1.1	0.3	2.3	6.1	0.4	2.8	22.6	100.0	5,021
Thailand	1970	39.0	0.7	50.5	0.4	2.0	1.2	0.0	0.0	0.1	0.0	0.3	5.2	100.0	710
	1978	23.5	0.1	51.3	0.5	4.3	6.4	0.0	2.7	3.6	0.0	2.3	22.0	100.0	4,085
	1983	16.1	0.4	51.7	0.9	6.3	4.9	0.3	4.7	6.4	0.1	2.4	30.3	100.0	6,368
Japan	1970	17.7	0.0	3.3	6.4	4.6	9.0	10.4	12.3	2.4	17.8	6.2	77.8	100.0	19,319
	1978	14.6	0.3	1.0	5.2	3.0	3.9	16.3	15.2	0.5	28.1	2.3	83.4	100.0	97,543
	1983	11.0	0.3	0.8	4.6	3.3	3.6	18.0	19.2	0.4	26.6	3.0	86.9	100.0	146,927
United States	1970	17.0	3.9	16.0	8.9	3.5	1.4	19.6	7.0	0.5	15.1	2.6	63.6	100.0	43,224
	1978	11.8	2.8	19.8	9.4	2.9	1.6	19.5	6.2	0.5	15.6	2.5	65.0	100.0	143,663
	1983	12.9	4.8	17.5	9.9	2.8	1.2	19.9	8.2	0.5	14.2	2.7	66.2	100.0	200,538

[a] 1982 is latest year available for Korea, Malaysia, and Philippines.

[b] Taiwan's electrical machinery for 1970 includes office machines and automatic data processing equipment. 1985 is the latest year available for Taiwan.

Sources: United Nations, Yearbook of International Trade Statistics, 1972-73, 1981, 1982, 1983.
Department of Statistics, Ministry of Finance, Monthly Statistics of Exports and Imports, The Republic of China (Taiwan District), February 20, 1986.

Table 10
Domestic Saving, Investment, and Resource Balance
(as a percentage of GDP)

	Gross Domestic Saving		Gross Domestic Investment		Resource Balance	
	1960	1984	1960	1984	1960	1984
NICs						
Hong Kong	6	29	18	24	-12	5
Korea, Rep. of	1	30	11	29	-10	0
Singapore	-3	43	11	47	-14	-4
Taiwan	13	33	20	22	-7	12
ASEAN						
Indonesia	8	20	8	21	0	-1
Malaysia	27	32	14	31	13	1
Philippines	16	18	16	18	0	-1
Thailand	14	21	16	23	-2	-2
U.S	19	16	18	19	1	-3
Japan	34	31	34	28	0	3

Sources: World Bank, World Development Report, 1982, 1986, Table 5.
ADB, ADB Annual Report, 1985.

Table 11
Capital-Output Ratio and Saving Rate

Country	Incremental Capital-Output Ratio 1966-1975	Incremental Capital-Output Ratio 1976-1982	Marginal Saving Rate (%) 1966-1975	Marginal Saving Rate (%) 1976-1982
NICs				
Hong Kong	2.8	2.5	24.3	24.6
Korea, Rep. of	2.7	4.3	24.6	31.2
Singapore	3.2	4.3	33.8	48.2
Taiwan	3.0	3.8	29.1	31.9
ASEAN				
Indonesia[a]	2.2	3.3	18.0	22.6
Malaysia	3.2	3.7	24.6	26.0
Philippines	3.3	4.7	26.5	21.8
Thailand	3.3	3.7	24.2	21.8

Source: Seiji Naya and William James, "External Shocks, Policy Responses, and External Debt of Asian Developing Countries," a paper presented at the 14th PAFTAD Conference, Singapore, June 1984, Table 11.

Table 12
Selected Financial Indicators
(In percent)

	Inflation Rate[a]	
	Avg. 1971-1980	Avg. 1981-1985
NICs		
Hong Kong	8.5	9.2
Korea	16.5	7.4
Singapore	6.7	3.3
Taiwan	11.1	4.1
ASEAN-4		
Indonesia	18.0	9.7
Malaysia	6.0	4.7
Philippines	13.8	21.3
Thailand	10.0	5.0

[a] Average percentage change in consumer prices over previous year, calculated from indexes.

Sources: ADB, Key Indicators of DMCs of ADB, October 1985, (various issues).
IMF, International Financial Statistics, Yearbook 1986, (various issues).

Table 13: Direction of Imports and Exports

Direction of Imports (as percent of total imports in c.i.f. values)

TRADING PARTNER

IMPORTING COUNTRY	1970					1978					1985				
	NICs	ASEAN4	US	JAPAN	EEC	NICs	ASEAN4	US	JAPAN	EEC	NICs	ASEAN4	US	JAPAN	EEC
NICs	5.1	11.6	17.8	29.3	13.8	6.3	9.7	17.7	21.4	11.5	8.1	8.7	19.9	19.3	10.2
Hong Kong	8.1	3.8	13.2	23.8	18.2	15.0	3.7	11.9	22.8	14.2	17.9	2.8	9.5	23.1	11.6
Korea	3.3	6.1	29.5	41.0	10.5	1.8	4.9	27.2	17.5	12.5	3.3	6.6	34.8	14.8	10.0
Singapore[a]	4.6	28.1	10.6	18.9	15.2	5.5	24.0	11.5	17.4	10.6	6.9	20.7	14.5	16.3	10.8
Taiwan[b]	3.1	6.8	23.9	42.9	8.1	3.4	6.0	21.6	33.4	9.4	3.9	5.7	23.6	27.6	9.5
ASEAN-4	7.5	4.0	17.3	28.4	20.8	11.8	3.8	15.1	27.9	16.2	16.1	6.1	15.4	23.8	15.9
Indonesia	11.5	1.9	17.9	29.4	21.6	15.2	3.0	12.5	30.1	18.7	12.3	1.3	14.4	28.1	21.7
Malaysia	10.9	8.6	8.6	17.5	23.3	12.9	5.8	13.9	23.1	18.1	21.5	6.5	15.3	23.0	14.4
Philippines	3.0	2.3	29.4	30.6	15.4	7.8	4.5	21.1	27.5	12.6	15.2	11.9	25.1	14.0	8.5
Thailand	5.0	2.2	14.9	37.4	22.6	10.2	1.9	13.7	30.7	14.5	13.2	7.1	11.2	26.0	16.4
Japan	3.5	9.4	29.6	--	8.2	7.2	11.4	18.7	--	7.7	7.9	12.9	20.0	--	7.2
U.S.	4.9	2.6	--	14.7	23.1	7.8	3.9	--	14.2	16.8	11.2	3.1	--	20.0	19.8

Direction of Exports (as percent of total exports in f.o.b. value)

DESTINATION

SOURCE	1970					1978					1985				
	NICs	ASEAN4	US	JAPAN	EEC	NICs	ASEAN4	US	JAPAN	EEC	NICs	ASEAN4	US	JAPAN	EEC
NICs	7.3	10.2	31.2	11.5	15.1	7.8	8.7	29.6	12.6	14.8	8.4	7.0	34.7	10.0	10.3
Hong Kong	5.7	4.7	35.7	7.1	21.3	7.2	6.8	30.4	7.7	21.8	5.6	3.6	30.8	4.2	12.3
Korea	6.3	1.2	47.1	28.1	7.6	5.2	2.5	32.0	20.7	14.7	7.6	2.7	36.2	15.5	10.4
Singapore[a]	4.9	27.8	10.7	7.3	15.1	9.2	22.3	15.4	9.3	12.1	8.6	22.2	20.8	9.4	10.4
Taiwan[b]	13.5	5.8	38.1	14.6	9.3	10.2	5.7	39.5	12.5	11.3	12.0	3.1	48.1	11.3	8.3
ASEAN-4	19.0	3.9	19.6	29.9	13.1	16.5	3.2	22.4	29.5	14.9	18.9	4.5	20.2	32.1	11.9
Indonesia	17.5	5.6	13.0	40.8	5.9	15.7	2.0	25.4	39.2	7.5	12.8	1.9	22.7	49.1	6.6
Malaysia	27.0	3.3	13.0	18.3	19.3	22.3	2.4	18.6	21.7	18.4	29.5	6.2	12.8	24.6	14.4
Philippines	6.8	0.3	41.5	40.1	7.3	8.0	4.0	33.8	24.2	18.6	13.1	6.0	35.9	19.0	14.0
Thailand	20.0	8.0	13.5	25.5	18.3	15.7	7.3	11.0	20.3	26.4	15.7	6.3	19.6	13.3	18.9
Japan	13.7	7.2	31.1	--	9.6	15.1	6.5	25.8	--	12.3	12.8	4.2	37.6	--	11.9
U.S.	4.2	2.0	--	10.8	26.1	5.8	2.2	--	9.0	22.8	7.8	2.1	--	10.6	23.0

[a] Singapore does not record trade with Indonesia. Singapore's trade with Indonesia is derived from Indonesian data. To account for costs of freight and insurance, Indonesian exports are multiplied by 1.1 and shown as estimates of Singapore's imports from Indonesia. Indonesian imports are divided by 1.1 and shown as estimates of Singapore's exports to Indonesia.

[b] All countries' trade with Taiwan are derived from Taiwan's own record. Taiwan's exports data are shown as estimates of various countries' imports from Taiwan. Taiwan's imports data are shown as estimates of various countries' exports to Taiwan. For example, Taiwan's exports data to Country A are multiplied by 1.1 to account for costs of freight and insurance and shown as A's imports from Taiwan.

Sources: International Monetary Fund, Direction of Trade Statistics Yearbook, 1970-76, 1985, 1986.
Department of Statistics, Ministry of Finance, Monthly Statistics of Exports and Imports, The Republic of China (Taiwan District), February 20, 1986.

Table 14: TRADE DEFICIT OF THE US WITH ITS TRADING PARTNERS
(as percent of total US deficit)

Country Group	1982	1983	1984	1985
World (US$ mn)	(42,508)	(69,352)	(123,281)	(148,468)
NICs	18.25	18.19	17.10	15.39
Hong Kong	8.08	6.15	4.73	4.18
Korea, Rep. of	1.13	2.50	3.28	3.20
Singapore	na	na	0.36	0.63
Taiwan	11.25	10.69	8.72	7.37
ASEAN-4	6.69	7.26	5.51	4.48
Indonesia	5.83	6.04	3.77	2.79
Malaysia	0.52	0.75	0.79	0.58
Philippines	0.24	0.51	0.69	0.64
Thailand	0.10	na	0.25	0.47
Latin America	12.84	25.76	16.53	12.18
Japan	44.51	31.24	29.85	33.51
Canada	30.68	20.62	16.54	14.94
EEC	na	na	10.48	15.24

na = not applicable, i.e., the US has a trade surplus with this country.

Source: International Monetary Fund, Direction of Trade Statistics Yearbook, 1986.

Table 15: Exports of United States by Principal Commodity and Destination
(as a percentage of exports in each commodity group)

COMMODITY GROUP	DESTINATION									
	Total LDCs	NICs	ASEAN	Latin America[a]	Total DCs	Japan	Canada	EEC[b]	World	Total Export to the World (US$ bn)
Raw Materials										
1970	22.62	3.54	1.74	11.31	75.71	22.22	14.93	18.98	100.00	7.35
1976	24.70	6.73	1.63	11.08	73.61	22.22	18.83	24.39	100.00	14.81
1984	30.17	11.44	1.66	12.01	66.34	20.86	16.98	21.81	100.00	27.25
Agr. & Food Products										
1970	31.31	5.10	2.83	9.47	67.18	15.89	12.19	22.37	100.00	6.92
1976	28.51	5.06	1.91	8.32	59.32	14.57	7.19	28.92	100.00	22.10
1984	38.58	7.69	2.13	13.86	50.07	17.78	5.81	17.29	100.00	35.77
Manufactured Products										
1970	28.67	3.13	1.84	16.10	68.40	6.77	24.90	17.09	100.00	27.40
1976	36.35	4.48	2.56	16.39	60.42	4.75	25.35	19.71	100.00	75.36
1984	32.68	7.77	3.11	13.37	64.20	7.55	24.83	22.59	100.00	144.62
Chemicals										
1970	33.44	3.04	1.71	19.28	65.58	8.42	14.62	24.69	100.00	3.84
1976	36.00	4.62	2.49	22.79	63.11	8.54	14.39	29.15	100.00	10.03
1984	36.62	8.87	3.28	17.64	59.31	13.18	12.62	24.56	100.00	22.63
Non-electrical Machinery										
1970	30.64	3.18	2.28	17.00	68.14	7.42	22.10	18.56	100.00	8.43
1976	38.01	4.15	2.38	17.20	58.54	3.98	23.00	19.91	100.00	22.20
1984	30.60	7.13	1.80	12.16	67.79	6.59	21.93	28.74	100.00	44.02
Electrical Machinery										
1970	30.97	6.34	1.86	16.15	68.17	7.97	20.26	19.96	100.00	3.03
1976	46.27	10.03	5.95	17.76	52.82	4.90	16.81	20.86	100.00	9.51
1984	48.90	13.67	11.32	17.31	50.60	6.72	15.61	20.31	100.00	19.02
Transport Equipment										
1970	21.99	0.98	1.16	12.64	69.08	4.36	37.40	12.38	100.00	6.54
1976	34.66	1.89	1.90	12.16	58.53	2.25	38.17	9.86	100.00	18.32
1984	22.97	4.93	1.24	7.80	69.80	4.47	3.12	11.97	100.00	29.99
Total Commodities										
1970	29.33	4.19	1.98	14.25	69.82	10.76	21.01	19.49	100.00	43.23
1976	34.21	4.98	2.30	14.18	62.28	8.82	20.96	22.10	100.00	114.99
1984	32.43	7.97	2.65	12.98	61.81	10.64	21.25	21.21	100.00	217.89

[a] LAIA, CACM, Caribbean.
[b] Belgium-Lux., Denmark, France, Germany, Greece, Ireland, Italy, Netherlands, United Kingdom.

Source: United Nations, Commodity Trade Statistics, 1970, 1976, 1984.

Table 16: Types of Net Financial Flows from OECD, OPEC, and Multilateral Institutions, Annual Averages

Year	Total Flows (US$ mn)	Growth Rate of Total Flows (%)	Percentage Shares of Total Flows					
			Official Flows			Private Flows[a]		
			Total	Bilateral	Multilateral	Total	DI	PI
ALL LESS DEVELOPED COUNTRIES								
1970-72	16,326.5	9.05	na	na	na	na	na	na
1973-75	33,076.5	43.88	na	na	na	na	na	na
1976-78[b]	60,132.7	16.07	47.85	33.73	14.13	60.41	17.80	26.97
1979-82	88,204.7	4.19	47.76	33.35	14.41	52.24	15.08	17.00
1983-84	79,385.2	1.01	54.45	35.06	19.39	45.55	12.21	5.77
1970-84[c]	56,013.1	15.05	48.69	33.33	15.36	51.36	14.64	15.83
NICs								
1970-72	1,087.2	5.85	57.15	45.35	11.90	42.85	na	na
1973-75	1,491.8[d]	17.63	53.93	36.31	17.61	46.07	na	na
1976-78	2,048.2	6.69	44.20	26.04	18.15	55.80	19.70	3.82
1980-82	3,978.6	28.67	28.68	17.96	10.72	71.32	33.22	13.08
1983-84	3,388.6	14.62	21.27	8.14	13.13	78.73	42.02	41.99
1970-84	2,438.2[d]	15.63	35.54	22.19	13.36	64.46	42.58[e]	23.52[e]
ASEAN-4								
0-72	1,193.8	15.14	70.14	60.83	9.31	29.86	na	na
1973-75	2,512.5[d]	47.77	49.28	35.20	14.08	50.72	na	na
1976-78	3,266.6	9.33	55.29	34.34	20.96	44.71	19.11	11.64
1979-82	5,509.1	22.70	52.60	27.52	25.08	47.40	20.33	11.29
1983-84	7,296.0	10.19	55.77	28.95	26.82	44.23	10.51	19.88
1970-84	3,836.5[d]	21.86	54.52	32.12	22.40	45.48	22.84[e]	18.91[e]

[a] DAC countries only; No private flows recorded from other countries or agencies. Export credits are also included in private total.

[b] 1977-78 for official and private flows.

[c] 1977-84 for official and private flows.

[d] Sum of components; does not add to total given in source (1975 only).

[e] 1976-84 only.

DI = direct investment.

PI = portfolio investment; this category corresponds largely to bank sector loans.

na = not available.

Net inflows are indicated by positive numbers and net outflows by negative ones.

See Appendix 4.2 for raw data and country detail.

Source: OECD, Geographical Distribution of Financial Flows to Developing Countries various issues, most recently published figures used (Asian LDCs, 1976-1984; All LDCs, 1969-84).
OECD computer tape as cited in ADB mimeos, no date (Asian LDCs, 1969-75).

Table 17
Debt Service Ratio: Principal and Interest
as Percentage of Export Earnings, 1981-86

	1981	1982	1983	1984	1985*
Indonesia	13.0	16.5	18.4	19.0	23.1
Malaysia	3.5	5.6	5.9	7.7	8.6
Philippines	17.7	23.9	22.6	17.9	32.2
Thailand	14.3	17.0	21.0	23.4	21.9

Note: The numerator does not include interest on short term debt. The denominator is exports of goods and services including workers' admittances.

*Estimates

Sources: World Bank, World Debt Tables;
1985-86 edition.
IMF, IFS, August 1986.

Table 18: Total Net Direct Foreign Investment Inflows (DFI)[a] and Gross Domestic Capital Formation (GDCF) in Asian Less Developed Countries

		Annual Averages				Total
		1965-69	1970-74	1975-79	1980-84	1965-84
NICs						
Korea	DFI	5.1	77.3	71.3	71.8	1,127.1
	% of GDCF	0.43%	2.62%	0.61%	0.36%	0.63%
Singapore	DFI	32.7[b]	277.1	655.2	1,708.2[c]	11,592.6[d]
	% of GDCF	8.97%[b]	20.50%	25.65%	26.87%[c]	25.17%[d]
Taiwan	DFI	25.5	57.1	79.3	154.1	1,579.7
	% of GDCF	2.85%	2.03%	1.14%	1.21%	1.35%
ASEAN-4						
Indonesia	DFI	6.7[b]	79.2	312.0	211.6	3,034.2[e]
	% of GDCF	0.98%[b]	3.29%	3.51%	1.06%	1.92%[e]
Malaysia	DFI	51.0[b]	210.2	442.0	1,179.5	9,311.8[e]
	% of GDCF	9.61%[b]	14.35%	12.80%	13.24%	13.17%[e]
Philippines	DFI	-6.4	4.1	109.6	35.9	716.1
	% of GDCF	-0.42%	0.18%	1.67%	0.36%	0.71%
Thailand	DFI	44.6	83.4	63.7	276.0	2,338.1
	% of GDCF	3.57%	3.85%	1.19%	3.09%	2.65%

na = Comparable data not available. Data were unavailable for Hong Kong.

[a] Expressed in US$ million.
[b] Refers to 1967-69.
[c] Refers to 1980-83.
[d] Refers to 1967-83.
[e] Refers to 1967-84.

Sources: International Monetary Fund, Balance of Payments Statistics Yearbook, various issues (most recently published figures).
International Monetary Fund, International Financial Statistics, 1982 Yearbook (1965-79) and 3/1986 periodical (1979-84).

Table 19: U.S. Direct Investment Position Abroad by Country at Year End

	1966	1977	1982	1983	1984	1985
World Total (US$ mn)	51,792	145,990	207,752	207,203	212,994	232,667
Percentage of World Total						
Developed Countries	68.14	75.43	74.31	75.16	73.93	74.25
Japan	1.41	3.15	3.08	3.70	3.72	3.91
Developing Countries	26.77	21.78	23.13	22.08	23.54	23.41
Other Asia & Pacific	2.53	3.77	5.97	6.29	7.10	6.39
NICs	0.49	1.71	2.80	2.94	3.13	2.81
Hong Kong	0.24	0.91	1.37	1.48	1.53	1.34
Korea	0.08	0.27	0.33	0.28	0.34	0.33
Singapore	0.06	0.35	0.83	0.88	0.91	0.82
Taiwan	0.11	0.18	0.26	0.30	0.35	0.32
ASEAN-4	1.35	1.73	2.70	2.97	3.53	3.14
Indonesia	0.20	0.67	1.10	1.34	1.87	1.76
Malaysia	0.11	0.32	0.59	0.56	0.55	0.52
Philippines	0.94	0.57	0.63	0.64	0.59	0.42
Thailand	0.10	0.16	0.38	0.43	0.51	0.44
China	na	na	0.02	0.05	0.10	0.10

na = not available.

Sources:
1966 data: US, DOC, BEA (1982), Selected Data on U.S. Direct Investment Abroad, 1950-76, pp. 201-203 (based on 1966 benchmark survey).
1977 data: US, DOC, BEA, Mimeos, 8/24/1984 (based on 1977 benchmark survey).
1982-85 data: Survey of Current Business, Vol. 66, No. 8 (August, 1986), pp. 46-49, 70-71 (based on 1982 benchmark survey).

Table 20: U.S. Direct Foreign Investment Position Abroad by Region, Country, and Sector at Year End

	Industries (US$ mn)	As Percent of All Industries				
		Mining	Petroleum	Total Manuf.	Manuf. of Elec. Equip.	Other
World						
1966	51,792	7.93	27.29	42.17	na	22.60
1977	145,990	4.11	19.20	42.48	3.76	34.21
1985	232,667	na	25.08	41.08	3.80	33.84
Developed Countries						
1966	34,311	6.75	22.30	51.16	na	19.78
1977	110,120	3.77	21.10	45.84	3.83	28.84
1985	172,750	na	21.20	43.91	3.49	34.89
Japan						
1966	783	0.00	35.50	53.13	na	11.37
1977	4,593	0.00	31.50	42.85	2.72	25.65
1985	9,095	na	23.95	50.81	3.71	25.23
Developing Countries						
1966	14,314	12.24	36.07	27.82	na	23.88
1977	31,800	5.81	4.77	36.31	4.00	53.12
1985	54,474	na	31.78	36.22	5.16	32.00
Other Asia and Pacific						
1966	1,366	D	38.95	33.46	na	17.64
1977	5,503	1.80	39.56	27.19	6.27	31.44
1985	14,874	na	41.62	23.79	9.80	34.58
NICs						
Hong Kong						
1966	143	0.00	25.17	20.28	na	34.97
1977	1,328	0.00	20.41	15.14	4.44	64.46
1985	3,124	na	11.24	10.92	1.02	77.78
Korea						
1966	46	0.00	D	36.96	na	0.00
1977	295	0.00	D	41.52	4.30	9.37
1985	757	na	0.53	28.01	4.49	54.43
Singapore						
1966	33	0.00	D	15.15	na	0.00
1977	516	0.00	44.96	20.54	8.72	34.69
1985	1,397	na	19.40	51.29	32.05	29.31
Taiwan						
1966	62	0.00	D	50.00	na	6.45
1977	259	0.00	6.18	68.73	33.98	25.10
1985	754	na	-1.06	73.21	23.87	27.72
ASEAN-4						
Indonesia						
1966	106	0.00	90.57	0.00	na	8.49
1977	984	D	74.80	9.86	1.32	2.24
1985	4,087	na	90.78	2.47	D	5.11
Malaysia						
1966	59	6.78	D	18.64	na	11.86
1977	464	0.86	D	18.53	9.91	5.17
1985	1,217	na	49.63	37.22	29.01	9.94
Philippines						
1966	491	D	33.60	35.85	na	20.57
1977	537	0.00	32.62	37.87	4.06	29.51
1985	983	na	4.78	39.57	11.09	55.75
Thailand						
1966	52	0.00	D	34.62	na	11.54
1977	237	2.53	D	21.52	4.64	17.30
1985	1,022	na	75.15	12.23	8.51	12.62

D = not disclosed.
na = not available.

Sources:
1966 data: US, DOC, Social & Economic Statistics Administration, BEA (1974?), *U.S. Direct Investment Abroad, 1966 Final Data*, pp. 41 (allocated value of direct investment position; results of 1966 benchmark survey).
1977 data: US, DOC, BEA, Mimeos, 3/24/1984 (based on 1977 benchmark survey).
1985 data: *Survey of Current Business*, Vol. 66, No. 8 (August, 1986), p. 49 (based on 1982 benchmark survey).

Table 21: U.S. Direct Investment Income from Abroad by Country

	1966	1977	1982	1983	1984	1985
World Total (US$ mn)	5,259	19,673	21,380	20,499	21,509	34,320
Percentage of World Total						
Developed Countries	50.58	60.43	54.06	67.33	65.54	77.77
Japan	1.65	3.04	2.52	5.39	3.51	4.64
Developing Countries	45.12	39.06	41.12	27.75	31.88	21.43
Other Asia & Pacific	3.31	6.65	16.40	15.90	16.82	9.38
NICs	0.68	2.99	6.34	5.93	6.18	3.54
Hong Kong	0.49	1.95	3.03	2.51	2.09	1.51
Korea	0.04	0.24	0.36	0.25	0.79	0.50
Singapore	0.02	0.49	2.36	2.49	2.41	1.20
Taiwan	0.13	0.31	0.60	0.68	0.89	0.33
ASEAN-4	1.94	3.83	9.64	9.83	10.77	5.74
Indonesia	0.84	3.03	8.21	7.95	8.36	4.10
Malaysia	0.11	0.23	1.33	1.86	1.79	0.97
Philippines	0.97	0.46	0.22	0.01	0.39	0.28
Thailand	0.02	0.11	-0.13	0.00	0.24	0.39
China	na	na	-0.01	-0.23	-0.46	-0.24

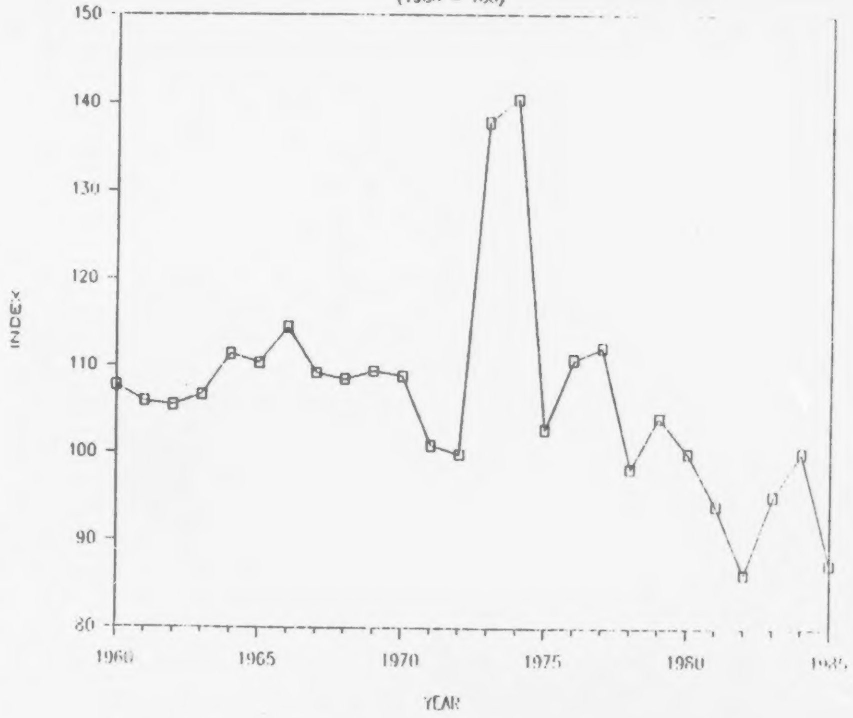
D = not disclosed.
na = not available.

Sources:
1966 data: US, DOC, BEA (1982), Selected Data on U.S. Direct Investment Abroad, 1950-76, pp. 213-15 (based on 1966 benchmark survey).
1977 data: US, DOC, BEA (1981). U.S. Direct Investment Abroad, 1977, p. 83 (results of 1977 benchmark survey).
1982-85 data: Survey of Current Business, Vol. 66, No. 8 (August, 1986), pp. 66-69, 70-71 (based on 1982 benchmark survey).

Figure 1

INDEX OF REAL COMMODITY PRICES

(1980 = 100)



Source: International Monetary Fund, Primary Commodities: Market Development and Outlook, May 1986.

Mr. STOKES. Thank you, Professor Naya.

Our next speaker will be Mr. Lawrence Krause, who is currently a senior fellow at the Brookings Institution here in Washington, and he will soon become Professor of International Relations and Pacific Studies at the University of California in San Diego. He is a well-known and well-published authority on NIC's and their relations with the U.S. and his paper will address those issues.

STATEMENT OF LAWRENCE B. KRAUSE, SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. KRAUSE. Thank you very much, Mr. Stokes.

This statement is as brief as it is because of the very useful background paper provided for this symposium by the Congressional Research Service, and I would like to recommend it to all the participants here.

It is now well recognized that the United States and the Asian NIC's have been developing very close economic ties over the last 25 years; in other words, we have become more interdependent. What happens in these countries matters to the United States, and what happens in the United States matters to them.

Each of the Asian NIC's has made remarkable economic progress. While sometimes described as an economic miracle, in fact there is nothing miraculous or mysterious about their economic success. It results from three factors: The society's willingness to work hard; a high rate of domestic savings; and the Government's willingness to let resources be allocated by the market—even if activist policies are used to encourage or speed up market action. The NIC's are following the Japanese approach to development, and are doing it twice as fast as Japan. At this stage in their development their economies are, in the main, complementary to the economy of the United States. That is, progress in the NIC's unambiguously leads to welfare improvement in the United States either through increased demand for U.S. exports, through the provision of U.S. imports at cheaper prices, or through other channels.

While there is some competition between industries in the NIC's and the United States, the two tend to produce somewhat different products so direct competition is only at the margin. Because of this, many cooperative ventures are being formed between American firms and enterprises in the NIC's. Furthermore, a pattern of cross-investment is developing. This is likely to be the mechanism through which interdependence will deepen in the future, and it will be welfare-promoting for both the United States and the NIC's.

However, all is not well in the international economic position of the United States, and this fact is reflected in our relations with the Asian NIC's. The United States is likely to amass a balance of trade deficit of $145 billion in 1986, and a current account deficit of almost an equal amount. Such a huge deficit is not sustainable. This generation of Americans has no right to squander its birthright and saddle future generations with the heavy burden of repaying foreign debts. Moreover, the trade imbalance is fermenting destructive trade protectionism in the United States which threatens world trading markets. Finally the huge trade imbalance requires constant financing and refinancing from abroad. If foreign investors lose confidence in the United States, the trade deficit will be ended abuptly with a huge loss of living standards in the United States. The trade deficit is going to be corrected one way or another. Only the questions of how and when remain to be answered. The correction can be done with healthy export expansion and efficient import replacement, or it can be done with market distorting measures, at great economic cost to both the United States and other countries.

The U.S. trade imbalance results fundamentally from the gigantic annual budget deficits of the United States. The budget deficit—in the face of U.S. households' unwillingness to save more, and business decisions to continue to make investments—forces the United States to borrow from abroad. This foreign borrowing led directly to a higher valued dollar in the foreign exchange market, a loss of U.S. competitiveness, and ultimately, a loss of market share both at home and abroad. Thus it is not what other countries did or did not do, but what we did to ourselves that caused the U.S. trade deficit.

A start has been made on reducing the budget deficit, the dollar has declined in value, and the trade accounts have begun to improve. However, none of these forces has gone far enough to correct the imbalance. The budget deficit must be brought down to a level of at least $60 billion or so, and the dollar must depreciate on average another 25 percent to 30 percent to enable the current account to be brought into equilibrium. This will take several years, but, if more serious damage is to be avoided, should be completed by the end of this decade. By the first half of the 1990's, the U.S. will have to be earning a considerable surplus in our trade accounts in order to service our foreign debts. Thus, much remains to be done.

The countries whose external accounts will deteriorate as the external position of the United States improves will most likely be the ones who are currently earning large overall current account surpluses, and especially those that have bilateral surpluses with the United States. This means primarily Japan, Europe, Canada, and the Asian NIC's. The bilateral relations of the United States and NIC's are already beginning to reflect this pressure. These countries' efforts to liberalize access to their own markets, and U.S. attempts to urge them along in this direction are highly desirable, and should be continued. Of course, Hong Kong and Singapore are essentially already at free trade so there is nothing more they can do.

On several occasions, however, the United States has urged these countries to restrain exports of particular products to the United States. These efforts are misguided. When successful (as they have been for several products), it is at immense expense to American welfare. Our consumers are hurt by much more than our producers benefit. If American producers need protection, then it must be enacted and enforced by the United States. Voluntary Export Restraints [VER's] are the very worst trade restriction for American welfare. This applies not only to such products as automobiles, but also to the multifiber arrangement for textiles. The United States should end its participation in the MFA and replace it, if necessary, with tariffs or an auctioned quota.

Measures to counter unfair trade actions are another matter. It is entirely appropriate to bilaterally negotiate with the NIC's to prevent or reverse dumping and export subsidies. However, it must be recognized that the legal industry in the United States is using unfair trade charges to harrass imports in order to earn legal fees from both American import-competing firms and foreign exporters to the United States. Unfair trade must be prevented. But it does no credit to the United States to write and enforce laws that permit our lawyers to exploit legitimate business at home and abroad.

The economic situation in the Asian NIC's has taken a turn for the better in 1986, and as already noted, this should bring benefits to the United States. The situation is particularly good in South Korea and Taiwan, both having benefited from a combination of lower raw material prices, especially oil, lower interest rates, and a partial correction of the undervalued Japanese yen—against whose products they compete. Hong Kong has not had quite so robust a year, but has still seen an expansion of its exports which has supported growth. Singapore, on the other hand, is finally coming out of a rather severe recession which began at the end of 1984. Unlike the others, Singapore has been hurt by the decline of oil prices, and in addition, has been feeling the negative consequences of the end of a construction boom.

If the industrial countries continue on their indicated growth path of about 2.5 percent per year, and world inflation is not reignited, then all of the Asian NIC's will do rather well—that is, they will grow faster than the world's average. Nevertheless, there will be economic changes in the NIC's. In Korea and Taiwan, economic structures will move farther away from labor-intensive products such as clothing and shoes, toward capital- and skilled labor-intensive products such as automobiles. It should be noted that in 1987 two additional Korean cars will be sold in the United States through cooperative arrangements with American companies. A Taiwanese-United States joint venture will also be exporting cars from Taiwan to Canada. The cooperative arrangements worked out in the automoibile industry may become a pattern in industrial relations for other industries as well.

Korea and especially Taiwan have now reached positions of balance-of-payments surplus on current account. It is not appropriate for them, from their own point of view, to be net lenders to the rest of the world—although in the case of Korea, some repayment of foreign bank debt is appropriate. For the future, both countries need to correct their surpluses—in their own interest—which will also help the United States correct its imbalance. The most appropriate instrument for correcting their surpluses is appreciation of their currencies. Up until now, Korea and Taiwan have more or less let their currencies remain fixed to the U.S. dollar. Thus, as the dollar declined vis-a-vis other currencies—and the yen in particular—the Korean won and the New Taiwan dollar also depreciated on average. That is no longer appropriate. The New Taiwan dollar is already slowly appreciating, and in the future I expect the Korean won to closely follow the Japanese yen. Thus, as the yen appreciates relative to the dollar—and I expect at least a 35 percent appreciation over the next 3 years—the Korean won is likely to appreciate relative to the U.S. dollar, possibly by 25 percent or so. The Singapore dollar was in a much different situation in that it was probably overvalued a bit, and Singapore has not been in current account surplus.

One cannot discuss the economic outlook for the Asian NIC's without paying some attention to their political situations. Major changes are taking place in three of the four countries. For Hong Kong, the change will not occur until 1997 when sovereignty over the Crown Colony passed to Mainland China. However, preparations are already beginning. A recent survey indicated that a significant minority of Hong Kong's residents were prepared to leave the area if the Chinese administration really changes their way of life. Making a reality of "two systems-one country" will clearly be a challenge for all involved.

Political changes are also taking place in Taiwan. This is inevitable given the ages of the political leaders that came over from the Mainland in 1949. The two most important developments are the ending of martial law and the legalization of opposition political parties. Martial law had little practical meaning for most of Taiwan's population, but it has symbolic importance. The legalization of the political opposition, on the other hand, is very important and should lead to increased politicization of life on the island.

Finally, Korea is going through what is for them a sui generis situation—and there are very few such occasions in history. For the first time ever a political leader of Korea has announced repeatedly, that he wants to voluntarily give up his power and transfer it to another leader through a constitutional mechanism. President Chun's one permitted term ends in early 1988—before the Olympic Games which are to be held in October. The political disputes that are now taking place in Korea—and they are many and fierce—are over the terms and conditions by which the successor to President Chun is chosen, not whether he should leave or not. This is a much different situation than occurred during the term of the late President Park, and also fundamentally different from the situation in the Philippines. In this historically new situation, no political force knows how to act—neither the Government nor the opposition. Thus, it is not surprising that there has been seeming turmoil. All those at home and abroad who wish well for Korea must hope that differences will be resolved by negotiation, that Korean democracy is placed on a firm path, and that a responsible and effective political leader who can command a consensus in the country is chosen.

I might conclude this brief statement by noting that a major change is occurring in the world economy. Japan is replacing the United States as the world's strongest economic power. It is in everyone's interest that the transition go smoothly. The last transition of economic power was marked by the Great Depression in the 1930's. While we have learned much from that earlier experience, danger is still present.

The shift to Japanese hegemony is bound to affect United States economic relations with the Pacific, and the Asian NIC's in particular. The basic complementarity between the U.S. and the NIC's means that we and they can enjoy beneficial two-way trade, while each manages his relations with Japan. For the NIC's, it means looking to Japan for a market where previously they looked to the United States. It may well be that Japanese direct investment in the NIC's will be the conduit through which NIC products finally pierce the Japanese market. Meanwhile, the prospects for cooperative business relations among United States, Japanese, and firms from the NIC's will grow, and out of these arrangements a new modality for managing world trade might be created.

In summary, the Pacific Basin is marked by uncertainty—both political and economic. This can be accepted as a creative tension that leads to the betterment of all countries, or it can lead to destructive conflict. The choice is mainly to be made by the United States. Thank you.

[The complete statement of Mr. Krause follows:]

Testimony of
Lawrence B. Krause*
Before the Joint Economic Committee
Congress of the United States
December 11, 1986

I wish to thank the Joint Economic Committee for inviting me to participate in this symposium on U.S.-Pacific Rim Relations. While the usual disclaimer with respect to the Brookings Institution still applies, I would like to bring to the Committee's attention my position on the Executive Committee of the U.S. National Committee for Pacific Economic Cooperation. Also I would like to inform the Committee that as of January 1, 1987, I will be joining the faculty of the University of California, San Diego in its new Graduate School of International Relations and Pacific Studies.

My statement will briefly cover five subjects: the evolving interdependence between the United States and the four Asian Newly Industrializing Countries (NICs), the U.S. trade imbalance, the bilateral trade relations of the U.S. with the Asian NICs, the economic situations and prospects for the NICs, and the evolving political situations there. The very useful background paper provided for this symposium by the Congressional Research Service, and particularly the contribution of William H. Cooper, makes it unnecessary for me to recite a lot of numbers or provide you with background tables for my remarks. For such material you should refer to the CRS paper.

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*Senior Fellow, The Brookings Institution. The views are those of the author and should not be attributed to other staff members, officers, or trustees of the Brookings Institution.

It is now well recognized that the United States and the Asian NICs--Hong Kong, Singapore, South Korea, and Taiwan--have been developing very close economic ties over the last twenty-five years; in other words, we have become more interdependent. What happens in these countries matters to the United States, and what happens in the United States matters to them.

Each of the Asian NICs has made remarkable economic progress. While sometimes described as an economic miracle, in fact there is nothing miraculous or mysterious about their economic success. It results from three factors: the society's willingness to work hard, a high rate of domestic savings, and the government's willingness to let resources be allocated by the market--even if activist policies are used to encourage or speed-up market action. The NICs are following the Japanese approach to development, and are doing it twice as fast as Japan. At this stage in their development their economies are, in the main, complentary to the economy of the United States. That is, progress in the NICs unambiguously leads to welfare improvement in the United States either through increased demand for U.S. exports, through the provision of U.S. imports at cheaper prices, or through other channels.

While there is some competition between industries in the NICs and the United States, the two tend to produce somewhat different products so direct competition is only at the margin. Because of this, many cooperative ventures are being formed between American firms and enterprises in the NICs. Furthermore, a pattern of cross investment is developing. This is likely to be the mechanism through which interdependence will deepen in the future, and it will be welfare promoting for both the United States and the NICs.

However, all is not well in the international economic position of the United States, and this fact is reflected in our relations with the Asian NICs. The United States is likely to amass a balance of trade deficit of $145 billion in 1986, and a current account deficit of almost an equal amount. Such a huge deficit is not sustainable. This generation of Americans has no right to squander its birthright and saddle future generations with the heavy burden of repaying foreign debts. Moreover, the trade imbalance is fermenting destructive trade protectionism in the United States which threatens world trading markets. Finally, the huge trade imbalance requires constant financing and refinancing from abroad. If foreign investors lose confidence in the United States, the trade deficit will be ended abruptly with a huge loss of living standard in the United States. The trade deficit is going to be corrected, one way or another; only the questions of how and when remain to be answered. The correction can be done with healthy export expansion and efficient import replacement, or it can be done with market distorting measures, at great economic cost to both the United States and other countries.

The U.S. trade imbalance results fundamentally from the gigantic annual budget deficits of the United States. The budget deficit--in the face of U.S. households' unwillingness to save more, and business decisions to continue to make investments--forces the United States to borrow from abroad. This foreign borrowing led directly to a higher valued dollar in the foreign exchange market, a loss of U.S. competitiveness, and ultimately, a loss of market share both at home and abroad. Thus it is not what other countries did or did not do, but what we did to ourselves that caused the U.S. trade deficit.

A start has been made on reducing the budget deficit, the dollar has declined in value, and the trade accounts have begun to improve. However, none of these forces has gone far enough to correct the imbalance. The budget deficit must be brought down to a level of at least $60 billion or so, and the dollar must depreciate on average another 25% to 30% to enable the current account to be brought into equilibrium. This will take several years, but, if more serious damage is to be avoided, should be completed by the end of this decade. By the first half of the 1990s, the U.S. will have to be earning a considerable surplus in our trade accounts in order to service our foreign debts. Thus much remains to be done.

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On several occassions, however, the U.S. has urged these countries to restrain exports of particular products to the U.S. These efforts are misguided. When successful (as they have been for several products), it is at immense expense to American welfare. Our consumers are hurt by much more than our producers benefit. If American producers need protection, then it must be enacted and enforced by the United States. Voluntary Export Restraints (VERs) are the very worst trade restriction for American welfare. This applies not only to such products as automobiles, but also to the Multifibre Arrangement for textiles. The U.S. should end its participation in the MFA and replace it, if necessary, with tariffs or an auctioned quota.

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In summary, the Pacific Basin is marked by uncertainty--both political and economic. This can be accepted as a creative tension that leads to the betterment of all countries, or it can lead to destructive conflict. The choice is mainly to be made by the United States.

Mr. STOKES. Thank you, Mr. Krause.

Our next speaker is also from the Brookings Institution. He is Mr. Kenneth Flamm, author of the book, "The Global Factory," a study of oversea production, a great deal of which is taking place in the Asian NIC's. He is also an expert on the international competition in the computer industry and will soon be publishing a number of books in that area.

STATEMENT OF KENNETH FLAMM, ECONOMIST, BROOKINGS INSTITUTION

Mr. FLAMM. Thank you very much.

I have been asked to come before you today and briefly make a few remarks about the nature of what is called offshore production and the significance of these types of trade flows to both the United States and the East Asian countries.

I would like to note that I'm going to pass very lightly over a number of important issues and refer you, for greater detail on any of the points I'm going to try to make, to a book which was coauthored with Joseph Grunwald and published by Brookings last year.

I want to talk about three things today. I want to briefly describe the nature of these types of trade flows and the history of their development very briefly. I would like to talk about current trends and future prospects for offshore assembly or offshore production. Finally, I'd like to recap what I think are the significant issues for the United States and what responses are called for.

Let me start out by talking briefly about what exactly it is I'm referring to and where it came from. Offshore production is often used as a synonym for assembly, production-sharing, complementary interindustry trade. All these terms refer essentially to the same phenomenon. That is, the export of a part of the production process for goods which use significant amounts of U.S. components in products which ultimately are shipped back to U.S. markets.

This type of trade relationship—that is, the export of a particular step in the production process for a good destined for the U.S. market—became a significant factor in the U.S. trade relations in the mid to late 1960's. In 1966, somewhat less than 4 percent of U.S. imports were imported under the special U.S. tariff provisions which were designed to permit offshore production. By 1983, this figure had grown two and a half times. About 10 percent of all imports would be classified as offshore production.

In terms of manufactured goods, since all these imports are manufactures, we are talking of perhaps 15 percent of U.S. manufactured imports.

The goods that are imported in this so-called offshore production trade are concentrated in a very small number of specific items. The most important is in products in the electrical and electronics industries, particularly semiconductors. Over 40 percent of the components involved in this type of trade relationship are in the semiconductor industry.

Together, if you add up all the different kinds of electronics goods involved—TV's, computers, subassemblies of various types, radios, electrical connectors and conductors, et cetera—you're talking about better than 60 percent of the components involved in this type of trade. The remainder is basically split up among textiles and apparel and, secondarily, among things like motors, engines, automobiles, and components and parts for automobiles.

The reason this particular narrow group of products is involved in this type of trade relation is primarily due to the characteristics of these products. They are all highly labor intensive. They have relatively high value-to-weight ratios and are transported quite cheaply relative to their value. They are mainly produced in relatively short production runs due to either rapid technological change or rapid changes in style or fashion. And for that reason, they are less amenable to what we call hard automation, an alternative production technique, because of their short production runs.

Historically, the shift to offshore production was a reactive strategy by U.S. firms. That is, U.S. firms reacted to foreign competition coming from relatively low-wage countries by shifting relatively labor-intensive stages of production offshore.

I'd like to talk next about recent trends and prospects for the future development of this trade. A lot of it, historically, has been connected with the East Asian NIC's. Over time there has been a move away from simpler products and toward more sophisticated products with higher technology content. Wages have climbed. The skill levels required for these products have also climbed and a hierarchy of developing countries in East Asia has developed.

The least developed countries produce simpler goods, most of them dependent upon unskilled, labor-intensive operations. Some of the more advanced countries, particularly Korea, Singapore, et cetera, produce more advanced goods which make greater use of more skilled labor inputs.

Second, this trade has been intimately related with high technology. It is associated with electronics and components, which all have relatively high-value-to-weight ratios and make large demands in terms of labor-intensive processes for assembly.

Most recently, however, a new trend has developed in this type of production. It is no longer just the low wage labor available in East Asia in the NIC's but also, to an increasing extent, cheaper components which have in very recent months become a significant factor in the move offshore. It's particularly wound up with the recent simiconductor agreement with Japan which has caused some firms, increasingly, to move offshore to take advantage of the availability of cheaper semiconductors in East Asia. So it's no longer necessarily just cheap labor pushing this move offshore, but also—due to recent policy changes—the availability of cheap components.

Fourth, I should note that this type of trade, offshore production, has increasingly been shifting away from East Asia in relative terms. That is due to the upward creep of East Asian wages in dollar terms, and more importantly, a downward creep or downward slide in wages in Latin America, in large part due to the economic troubles of that region and the devaluations and consequent cheapening of labor costs in Latin America, particularly Mexico. In relative terms more and more of this trade has been shifting toward Latin America in the last few years.

Not only do you find low labor costs in that region right now, but also you find some qualitatively different types of products being located in areas like Mexico, where transportation costs are much lower. Relatively heavy products with lower value-to-weight ratios are more commonly found than is typically true with the products assembled in East Asia.

I would argue that this is not entirely an unwelcome development, given the severe problems Latin America faces right now and the importance of that region to the United States. I think it is in the U.S. interest to encourage further development along these lines to Latin America.

The final point I'd like to make about trends in this particular type of trade is that automation is increasingly becoming a factor in limiting its future development. I don't mean to suggest that offshore assembly in Latin America or Asia is going to fall in absolute terms. Certainly the continued growth of high tech industries, particularly electronics, computers, components, et cetera, is going to lead to large absolute growth in these industries and hence in offshore assembly. But in relative terms, if you look at the proportion of that output that's produced offshore, you're going to see some shift back to the United States as a consequence of advances in automation.

In fact, I would argue you are seeing it right now. In semiconductors, for example, we have some numbers which are now available as a consequence of the trade litigation in that area. These numbers indicate, for example, that in 1983, something like 15 percent of the U.S.-produced 16K DRAM's chips were assembled in the United States. That figure more than doubled to 33 percent in 1984 and rose again to 37 percent in 1985. So we are seeing a relative shift away from offshore assembly due to automation in some of these products, even though the absolute amount of offshore assembly, I suggest, will continue to grow.

Particularly important in this shift and in future shifts which we will be observing is rapid technological advance in robotics after 1981. This technological advance is increasingly leading to major robotics investment in electronics assembly. I suggest that this, too, is going to play an important role in reducing the relative importance of offshore assembly, and it may well affect the continued growth of this type of activity in East Asia.

I'd like to conclude today's comments by talking about implications for the United States. I essentially have three observations to make.

First of all, in terms of negative impacts, the primary impact of this type of activity is on the least skilled sectors of the U.S. labor force. It is essentially the least skilled who are being laid off or being replaced as a consequence of this movement offshore, and it is in their relative incomes that the negative consequences of this movement are going to be seen.

Second, increasingly it is being suggested that protection of one sort or another might be used to stem this flow offshore. I would suggest to you that this would involve a considerable cost to the United States.

First, it would be a cost to the U.S. consumers who clearly would face higher prices for many of these goods. As a consequence of higher prices, one might also expect some contraction in demand in the United States and reduced exports and, finally, because of the contraction in output, more skilled, nonproduction employment might very well decline, even though low wage, unskilled assembly employment might be expected to increase.

In semiconductors, for example, I have done some calculations—rather rough calculations found in *The Global Factory* that nonetheless are instructive. The numbers suggest that if we could somehow ban all offshore imports of semiconductors and force production and assembly of all semiconductors to take place in the United States, it would create a cost to U.S. consumers equal to about 8 percent of the value of semiconductor consumption, plus or minus another 3 percent. So it's not an insignificant cost to consumers.

In terms of employment, if you were to simply ban all semiconductor imports, and protect the United States as a market, figures for 1977 suggest we might have gained perhaps 30 to 60 thousand unskilled assembly jobs in the United States but at the cost of perhaps 10,000 to 30,000 jobs which are at a substantially greater skill level—nonassembly jobs.

So even though protection might well augment or increase unskilled employment in certain tasks in the United States, there would be significant costs in terms of more skilled employment, in the total size of the American industry we're talking about.

I should note that these figures count only impacts within the semiconductor industry and do not count impacts on output and employment in other industries.

The final observation I'd like to make as far as implications for the United States goes is that the root problem for the United States is the least skilled at home who are competing with unskilled workers in less developed countries. The question is, how can we remove unskilled workers in the United States—whose wage generally is far higher than workers performing essentially similar tasks abroad—how can we remove them from competition with workers being paid at the much lower standards of living available abroad?

Well, there are essentially two approaches I would suggest to you. One of those approaches is to invest in technology, to increase our investments in things like automation which almost certainly will bring production back to the United States. The second approach involves investment in human resources. That is, putting resources into education, training, and skills. We can eliminate competition with the unskilled in the United States by reducing the numbers of unskilled in the United States, by making our labor force the more skilled, more educated, and more trained labor force.

Unfortunately, it can be argued that recent shifts in policy have left much to be desired in both areas. Our investments in technology are increasingly oriented toward military objectives. It's not at all clear that much of the massive resources we're putting into military technology projects are going to much benefit our commercial industry.

If you look at recent budget figures, they show Federal expenditures on basic and applied research in fiscal 1987 increasing at rather paltry rates—2 percent per year—while development projects largely inspired by military objectives are increasing at 19 percent over the next fiscal year.

We have cut back adjustment programs such as trade adjustment assistance and we are not investing the real resources that we used to invest in education and skills.

Protection does not address these problems. Protection puts off the day of reckoning. I would suggest to you that the way to deal with this problem and its impacts on the United States is to invest in technology and invest in our labor force.

I finally point out that one key problem is often overlooked when protection is suggsted as a short-term remedy for this movement offshore. These are mainly high technology industries, and if one believes, as I do, that the future of the United States is intimately linked with shifting toward more technology intensive economy, an economy in which technological rents—that is, gains from superior technology—play a significant role in our standard of living, then international markets are absolutely essential to our interests. Access to international markets is vital for these industries.

Protection sets a precedent that jeopardizes the access of our high technology industries to foreign markets. By setting this example we are in effect endangering the long-term interests of all of our high technology industries.

I suggest to you that this is something that bears careful thought and I will leave my comments at that. Thank you.

Mr. STOKES. Thank you, Mr. Flamm.

Our final speaker for the afternoon is Evelyn Colbert, currently a professorial lecturer at the School of Advanced International Studies of Johns Hopkins University. Prior to this she held the position of Deputy Assistant Secretary of State for East Asian and Pacific Affairs, and I believe Ms. Colbert will talk a bit about the ASEAN nations and their relations with the United States.

STATEMENT OF EVELYN COLBERT, PROFESSORIAL LECTURER, SCHOOL OF ADVANCED INTERNATIONAL STUDIES, JOHNS HOPKINS UNIVERSITY

Ms. COLBERT. Thank you, Mr. Stokes. Congressman Obey, I am very pleased and flattered to have been invited to participate in this symposium. I do feel that I am here perhaps slightly under false colors, so let me pin those false colors to the mast.

Unlike my distinguished colleagues here at the table, I am not an economist, have never been an economist, and I don't think really have the mental capacity for the kind of things in which economists engage.

I have been concerned with national politics and international politics and it is to both those subjects that I want to speak today, not as they relate to all of the NIC's that have been the subject of discussion here, but as they relate to one NIC, Singapore, plus a number of other near NIC's—that is to say, the ASEAN countries, the third tier countries as that excellent CRS report has described them.

What I want to do is raise a hypothetical question. I emphasize hypothetical, but not an impossible question or I wouldn't bother you with it.

The hypothetical question is this: If these third tier countries, if the ASEAN countries suffer a serious economic downturn in which they see, whether rightly or wrongly, U.S. policies as playing an important role, what are the consequences of such attitudes and such developments for American interest?

Let me take a minute first to review what those interests are. I know they are familiar, but I think it's worth at least itemizing.

First of all, the obvious strategic interest. It is certainly important to the United States that the key passageway between the Pacific and Indian Ocean, the Malacca Strait, is controlled by three literal countries that are friendly to us, and this is also important—friendly and cooperative with each other owing to their common membership in ASEAN.

The contribution that the Philippine bases make to our ability to maintain a favorable strategic balance in the Pacific is a major one. We are all aware of the importance of these bases in Korean contingencies, Persian Gulf contingencies, Indian Ocean contingencies. A less conspicuous but also I think an important contribution to this favorable balance of power in the Pacific is made by other ties, ties between the ASEAN countries and Japan, ties with Australia and New Zealand, ties with each other, all of which have been growing, forming a web of relationships of which, certainly, we are today only one part.

I have mentioned our strategic interest, but certainly they are not our only interest in this region. The importance of the economic relationship with the Pacific Rim in general has already been well brought out by my colleagues here. I would say that, in addition, the United States benefits, in ways, which are sometimes hard to define but are nevertheless important from the strength and cohesion of the ASEAN members. This strength in turn derives from the strength of the organization and contributes to the strength of the organization. The United States benefits from the ability of the ASEAN countries to deal effectively with their own problems and to resolve differences among themselves, relieving the United States of pressures we feel in other regions to take side between quarreling friends. The United States also benefits from the ability of the ASEAN members, of ASEAN as an organization to take the lead in efforts to resolve regional problems Cambodia of course is the most conspicuous example.

The close relationship that has developed between the United States and ASEAN since the mid-1970's has served our interests very well. We now have an active partnership with ASEAN and the ASEAN countries that has also served their interests. The ASEAN members see continued American military strength in the Pacific as vital to their own security. They have appreciated American support in dealing with Hanoi-generated problems, not merely Cambodia but also the enormous refugee problem.

They regard their close relationship with the United States as a contribution to the high status that ASEAN has won through its own unity and effectiveness. They recognize the important contribution that American trade, American investment, American technology, and the policies we have pursued in the global arena have made to their achievement of their own goals of national and regional resilience, in which they have made so much progress in recent years.

Now this picture—this optimistic picture—I think is today still the picture. But it is certainly beginning to fray a bit around the edges. The ASEAN countries have always had complaints about their economic relationship with the United States. This is inevitable in any trading relationship. But now they see the prospect that this relationship will become for them a very damaging one, owing to U.S. policies they see in some cases as already in effect, in some cases potential, a relationship that will threaten their own economic well-being and hence their political stability.

Now if these fears are correct—and I say again, this is a hypothesis, not a prophecy—what are the likely effects on U.S. strategic and political interests?

I would define these as falling into two somewhat different categories. One effect would be a decline in the American relationship with ASEAN and its members. The other would be the rise of unfavorable trends within the ASEAN countries, unfavorable not only to them but also I believe to our own long-term interests—unfavorable trends in the form of instability, pressure for radical solutions, perhaps revival of insurgency in countries where it has long ceased to be a problem.

The potential impact on our bilateral relationship is already very evident I think in the case of our old friend and ally, Thailand, where American rice and sugar policies are already seen as an important threat to national well-being,

The normally soft-spoken Thai are now expressing considerable bitterness about the United States and its policies. They ask whether American protestations of friendship, deep interest in Thai well-being, deep interest in Thai security, can be taken seriously. They question the sincerity of our repeated praise of their progress toward democracy if our policies are going to undermine the conditions that have made this progress possible. They say they understand that the United States had problems of its own, but they ask whether damaging the interests of 35 million Thai rice farmers and their families—70 percent of the Thai population—is the right way for a rich and powerful country to deal with the problems of a tiny segment of its own population.

They question whether in these circumstances the present close political cooperation between our two countries can survive. In the words of former Ambassador here in Washington, Kasim Kasemsi, in November, "U.S.-Thai relations may be in for a long, rough ride."

These sentiments are developing elsewhere in ASEAN and there is particular concern over the prospect of the reintroduction of the Jenkins bill. These fears may prove unfounded and the problem may go away, but suppose it doesn't? Should these feelings of grievance, these perceptions of mistreatment by the United States increase, what are the likely consequences?

The Soviet Union certainly is already looking to benefit. Already Soviet missions are running around Southeast Asia expressing understanding for the economic difficulties of the ASEAN countries, offering new trade deals, and presenting themselves as generous and helpful friends. And it is certainly true that any decline in the

U.S. position in Southeast Asia, in and of itself, constitutes a benefit to the Soviet Union.

But I think it would be wrong to focus on this outcome too exclusively because in fact there are very close limits on what the Soviets can accomplish in the way of translating their now great military power in the Pacific into the kind of political strength that we have enjoyed there for so long.

A first principle, often neglected, is that anger at the United States does not necessarily reduce the suspicion and fear with which Moscow is regarded. In the case of the ASEAN countries, they hold the Soviet Union responsible for Hanoi's persistence in Cambodia. As small countries, relatively defenseless countries, new countries, they identify with the victims of Soviet aggression. This is clearly the case today with respect to Afghanistan. But in the past, in the days when newly independent countries were developing their attitudes toward other countries of the world, Soviet behavior in Eastern Europe had considerable influence on the attitudes of Southeast Asian leaders. These factors aside, in trade terms, in economic terms, the Soviets have nothing very much to offer.

But I repeat, ASEAN does not have to leap into Soviet arms for American interests to suffer. The ASEAN countries, if their grievances against the United States became very strong, could join ranks with the more neutralist, the more radical Third World countries in circles where they are now a strong and helpful voice for moderation. They could become much less cooperative with the United States in policy areas that are not of direct interest to them. They could become more vocal and active in areas where their policies are already in conflict, at least to some degree, with those of the United States, the Middle East in particular. And they could become, as a group of countries, much less supportive of American interests in maintaining a base presence in the Philippines.

These are consequences that would affect our international position, our international interests. Not so obvious, but perhaps of greater long-term consequence, could be the impact of serious economic difficulties on the strength and stability of the ASEAN countries and hence of their organization.

It's not very long ago that these countries faced very serious threats from Communist insurgencies. Today, these problems, for the most part, are minimal. But we have seen how rapidly they can grow in the Philippines. In 1972, when President Marcos declared martial law, there were only a few thousand members of the NPA; in 1980, when there was still some glow in Marcos' policies, there were still only a few thousand. Today, as the combined consequence of authoritarian measures, violations of human rights, and acute economic hardship, the NPA has 15,000 full-time fighters, a large number of part-time fighters, and it exists in practically all of the 73 provinces of the Philippines.

To be sure, Communist insurgency is not the only source of tension. Ethnic differences, Islamic fundamentalism, civilian-military competition—these are other sources of tension that have been held very much in check in the ASEAN countries by the sharing of the fruits of prosperity and of economic growth that most of the peoples of ASEAN have enjoyed.

Lacking this economic advance, these tensions could become more explosive. Social scientists cannot tell us exactly what the connection is between economic growth, prosperity, and well-being and political stability and progress. But I think our experiences over the last decade certainly indicate that such a connection exists.

For some time now, 10 years or so, American spokesmen, Republicans and Democrats alike, have pointed with considerable gratification to progress in ASEAN as a showcase of free market economic policies, a showcase of pluralism, of progress toward democracy.

This is not our achievement. It is their achievement. Nevertheless, it is one to which we have contributed. I would ask today whether an important question will be answered positively—will we continue to make this contribution by our economic policies as well as by our political and security policies. Thank you.

Mr. STOKES. Thank you very much.

I would now ask all the panelists to respond to their fellow panelists' comments, also ask questions of their fellow panelists, and if any member of the panel would like to make a statement based on what others have said, we'll start with Mr. Naya.

Mr. NAYA. I would like to follow up Professor Colbert's point. I guess in my presentation I didn't really emphasize ASEAN. It seems to me that there is a great deal of difference between ASEAN and NIC's as far as economic development problems are concerned.

NIC's have been able to take advantage of the change in the exchange rate. Korea and Taiwan have been able to outcompete Japan to some extent in the American market. On the other hand, Japan is likely to increase imports. It is not really a conscious decision on the part of Japan, but it's forced upon them by the exchange rate change.

The ASEAN countries somehow, because of a much lower stage of industrialization, have not been able to take advantace of this new change in the exchange rate yet. In this region, the primary commodities have been down. Usually, primary commodity prices go up and down, but in this case, in the last several years, they have been down and stayed down and ASEAN has been hurt a great deal.

I can't help but think of the role of Japan here. Japan has been the largest trading partner of these countries, but somehow the technology has been such that Japanese imports, especially from ASEAN, have not really grown that fast.

So the ASEAN picture seems to be quite different from the NIC's and it's not just a rice problem between the United States and Thailand. There's also the chicken war. I don't know whether you heard about this boneless chicken and the boned chicken imported in Japan. There's a great deal of difficulty in exporting chicken to Japan, although now I understand they cannot produce enough chicken to send to Japan. The supply side is also very important for ASEAN.

As Larry mentioned, Singapore, for the first time, had a negative economic growth rate last year. I never heard of Singapore having a negative growth rate, but Singapore did have something like a 1 to 2 percent negative growth rate.

Indonesia is expected to grow only about 2 percent this year. Malaysia is likewise having all sorts of problems. The Philippines is recovering slightly to maintain the same position as last year.

Only Thailand seems to be doing quite well, but I think it seems to be quite a different picture between NIC's and ASEAN.

Mr. STOKES. Are there other panelists who would like to comment?

Mr. KRAUSE. Let me make one statement concerning the ASEAN countries and that is that they are resource driven, and therefore, there is nothing that comes even close to second importance to commodity prices for their welfare. This is not a problem the United States created, and indeed the United States is hurt by it in the main because we are a commodity exporter ourselves.

To the degree we influence prices, it is through the value of the dollar relative to other currencies. So when the United States inappropriately limits the devaluation of the dollar vis-a-vis the yen, then we hurt them by not raising the dollar price of raw materials.

Now where there's a commodity access problem is in Japan, not into the United States. It's Japan that sustains a rice price 11 or 12 times the world price—and that's the distortion in the rice market. The fact that the U.S. at one time supported the rice price above where it should be and now may be doing it the other way around, those are adjustment problems. But the problem begins in Japan. It is not a U.S. problem.

Mr. STOKES. Are there other comments?

Mr. FLAMM. I just wanted to point out that there's a link between the political factors that Ms. Colbert was talking about and the economic problems we've been describing, particularly in the Philippines.

If you look at the history and analysis of investment in offshore production facilities, there's a political risk to capital that has played a major role in explaining the production investment location decisions of producers. There's no doubt that political instability in the Philippines, and for that matter in El Salvador, has exacerbated the economic problems that those countries have faced in promoting export-oriented investments.

Ms. COLBERT. Let me try and cope in a very amateur sort of way with what Larry and Seiji both said about commodity dependency. This is certainly true and leads one to wonder whether there aren't certain advantages in being, as Japan is and Korea is up to a point, almost bereft of raw materials. It inspires you to move in a certain direction, whereas a wealth of commodities perhaps makes one complacement and makes one act as though high commodity prices would last forever. I think certainly some of Indonesia's difficulties were created at the same time that high oil prices were encouraging a tremendous improvement in the Indonesian economy, expectations that these prices would continue had effects that were not quite so good.

But it does seem to me that when we talk about commodity problems we have also to be very attentive to American policies in terms of our own search for markets and it is in this area where I think our Pacitic allies, including Australia, have found our policies to be damaging to their interests in ways that have had political repercussions.

Mr. **Stokes.** My only comment to follow up a bit on the others is that we have talked a great deal today about economics and in part I think tried to lay out the case of the NIC's, that they are somewhat different from Japan; they are not the next Japan for a variety of reasons, that the ASEAN countries have commodity problems, that the Asian NIC's are in fact a model for development and some are quite devoted to the free enterprise system and have quite open markets.

I think we may have given short shrift, though, to the reality of the political problems these countries face, notwithstanding the good case they came to be treated differently from Japan.

I think that's probably a challenge the next Congress will have to face, that because of the growing presence of the NIC's in the U.S. market and the economic problems facing this country, while none might wish that they could avoid some of the protectionist backlash, I think it is only natural and understandable that that backlash will hit them and hit them hard, and that it will be the task of this Congress and I think a number of the lobbyists that are now in the employ of the NIC countries—and that lobby in this Nation is of course getting much stronger—to have to deal with that political backlash, and I think that it would be very important for the NIC's to understand that while they may feel picked upon by the United States, there are political realities in this country which are not insubstantial and are terribly relevant to the Members of Congress who have to deal with those political realities, and it's not just a question of plants closing in their States but the perception of the body politic and what the problem is and whether that's real or not it still has to be dealt with.

I guess my closing comment would be that one of the consequences of the success of the NIC's in this market may well be to be welcomed into the political realities of the United States, and as one begins to play in the economic big leagues one must also begin to play, unfortunately for the NIC's, in the political big leagues of the United States. And that will be a tough task ahead.

We have a little bit of time and possibly, Congressman, do you wish us to go to questions? Are there questions or comments from the audience that people would like to make? If it is a comment, if you could keep it short. If it's a question, make sure it's a question and not a comment.

Voice. Mr. Krause, your statement that economic leadership—I don't have your statement right before me—has passed from the United States to Japan and that we should take steps to ease that transition, I think when we look at it it's certainly true, but I think that would suprise Members of Congress and their constituents.

Could you elaborate on why the United States is becoming No. 2 and why we should accept that?

Mr. **Krause.** Well, the elements of world economic power can be seen in trade, can be seen in direct investment, can be seen in finance.

If you look on the trade side, Japan is the world's largest surplus country. The United States is the world's largest deficit country.

Japan is the most strategic trader in the sense of moving into the fast-growing, high-technology areas.

In the trade area, Japan is doing extremely well. In the direct investment area—and Seiji Naya is quoting figures which are correct but, unfortunately, his data tends to be somewhat old—since the rise in the value of the yen, Japanese firms have been scouring the world for direct investment in order to produce goods they can no longer produce competitively in Japan.

Of course, we are aware of their investment in the United States which we see all the time, but it's happening elsewhere in the world as well.

So Japanese firms, direct investment firms, are going to be producing everywhere, while U.S. firms, with the value of the dollar dropping, are going to be encouraged to come back to the United States to invest. This is where it's going to be profitable for American firms to invest. It's going to be profitable for Japanese firms to invest abroad outside of Japan and, therefore, in their international position it will strengthen considerably.

In terms of finance, if you look at the five largest international banks in the world, four of them are Japanese. They are not American. And the top is Japanese.

If you look at the top 10, I think it's 7 that are Japanese. In the top 20, 12 are Japanese. We're talking about finance. They are the savers of the world. What sets the price of U.S. Treasury bonds at an auction—whether the Japanese are buyers that day or not? It is all around you that the Japanese are the dominant world economic power.

We could go into more detail, but that's the essence of it.

Now the second part of it. Why is it of interest to see that the transition goes smoothly? Well, we know from the experience in the 1930's that two things can happen. Britain denied that they were losing position, and the United States failed to take responsibility for the power it was gaining—and both were a disaster.

When the newly powerful country acts as if it's a small country, it doesn't take responsibility. When the powerful country acts as if—the power-losing country—acts as if it hasn't, it overstretches itself, weakening itself all the more and, therefore, making the divergence all that greater.

The most powerful country is required to protect the international system, to make investments in systems management, to keep the operations going. The United States no longer has the strength and Japan so far has not shown the inclination, and that's the transition that has to take place.

Voice. As a followup, could this be temporary? Some of what we hear is that Japan will have to be running trade deficits in the 1990's because the United States is going to have surpluses. Could we see, perhaps a quarter of a century after, some sort of equilibrium?

Mr. KRAUSE. The trade position will adjust through a change in the exchange rate and when it's over the average Japanese will be somewhere 25 to 30 percent richer than the average American, probably not twice as rich, so the absolute size of the U.S. income of the United States as a whole will be larger than Japan, but per capita they will be much richer than we are.

Why? Because they work 15 to 20 percent more than we do. It starts when they go to school. They work 6 days a week in school, work hard, and they achieve something. In the United States we go to school less, we work less, and we achieve less.

They save for the future. We don't. These are just characteristics. It could reverse. We could start saving more and working more, and they could save less and work less, but unless we see that sort of reversal, then you have to say that the Japanese will continue to be the strongest economic power in the world.

Mr. STOKES. Other questions?

VOICE. The Thai and ASEAN position taken last year to a group on another committee, responding to the Jenkins bill, was in addition to arguing against restrictions of the U.S. market, the argument was that their growth was tied to increased trade, particularly in processed and manufactured goods, and that the European Community and Japan were particularly closed markets and that the United States in the past had been a particularly open market and, therefore, it was important not only not to have U.S. protectionism but also to have openness in the other industrial markets.

To what extent do you feel that was a legitimate presentation?

Mr. NAYA. I think that's quite correct. As I mentioned in my presentation, ASEAN exports of manufactured goods to the United States are something like four or five times their exports of manufactured goods to Japan. So the United States has been the largest open market for their manufactured goods. Yet the size of manufactured goods from ASEAN is still very small. As these countries begin to industrialize, as they begin to make the structural changes away from primary product exports they have to find a market.

And as Larry mentioned, there's a limit to imports of large manufactured goods from Third World countries, and other countries have to assume the burden.

VOICE. Could you comment on the necessity for the ASEAN nations to have free trade, whatever rationale you use, and the U.S. closed market and the political dynamics as well?

Mr. NAYA. They have this ASEAN Corporation which started in 1967. The first summit meeting took place in 1976 and 1977 and since then, there hasn't been any summit meeting. The next summit meeting is going to be held in December of next year of 1987. Outsiders will begin to wake up and realize that the ASEAN Corporation isn't the kind of corporation we expected them to be. They are having all sorts of difficulty in trying to cooperate more.

I have a feeling that the ASEAN members will do more in the next summit meeting. It has been extremely difficult to engage in active cooperation, but they have done very well. All other countries have failed. Latin America has failed as far as cooperation is concerned. Africa has failed. Only ASEAN has been succeeding. But, in terms of regional cooperation, there is a lot more to be done. There are a number of difficult areas, but I have a feeling that they will move by then.

Mr. STOKES. Other comments or questions?

VOICE. In reaction to Ms. Colbert's point that we would like to see in the Philippines a situation where our ASEAN partners—and this is to the point of Mr. Naya about the summit—to see ASEAN support for the presence of the American bases in the Philippines.

We are confronted with a situation in which privately we are told that they would like to see the bases remain. At the same time, there are official pronouncements that as far as they are concerned they would like to pursue the SALT pact, the neutrality, and the thinking now in the Philippines has been more and more that ASEAN could take the political burden of these bases since it secures the Philippines and the ASEAN region.

So I thought I would like to contribute that to the discussion because I am expecting the possibility that this may creep up in terms of preparation for the summit next year.

Ms. Colbert. I can't profess to speak for the ASEAN countries on this point but I do think that attitudes may be changing.

One of the interesting features of the ASEAN organization has been the amount of creative ambiguity that has been involved in the cooperation of the ASEAN countries. Nominally ASEAN is an economic organization, nominally a nonaligned organization, an organization that has always said, "No, we will not become a military alliance for a whole host of reasons."

ASEAN countries normally when they engage in security activities of one kind or another in cooperation with each other, or in relationship to the United States, Australia, or New Zealand, do this as individual countries, not as ASEAN, the organization.

I think the Philippine proposal with respect to ASEAN support—formally, legally, or organizationally—for the maintenance of the bases there comes right up against this effort to distinguish ASEAN as a nonaligned organization and a nonmilitary organization from the policies of its individual members.

But I think there would be a great many differences among the ASEAN countries on how they approach this. I think Singapore, for example, might feel this would be a good idea, if only the others would go along with it. Indonesia, at the other extreme, I think might feel that this would be very much a compromise of very long-standing policies of nonalignment, independence, a threat to Indonesia's Third World status.

But I think that just as the Soviet military presence in Vietnam has made a difference in ASEAN's perception of external threats, so that same presence might result at least in more thought being given to this possibility, as you say, in preparation for the Summit, than would have been possible 5 years ago.

Voice. I know we're not discussing this type of problem, but I thought it might be useful to ask this panel how the developments in China are affecting the ASEAN development and NIC's and how they view development in China.

Mr. Stokes. Any response?

Mr. Naya. China exports about 10 percent of their total income and, as you know, China is such a large country that it cannot really be a major exporting coutry in tems of relative size.

There are both complementary and comparative aspects to the trade relationship and, as Larry said, we really don't know too much about that area.

Voice. I just heard Mr. Krause say that legislation was critical to the area. I was wondering what the basis for that is.

Mr. Krause. When you have a restriction in a market, then the value of the product rises. And the question is, where does the windfall go that is created between the cost of production and the higher value of the market? When it's a voluntary export restraint it goes abroad. It goes to the Japanese automobile producers that are rolling in money or in fact to the textile producers who now have such a valuable asset in the form of the ability to export to the U.S. they no longer even have to produce textiles. They sell that and live very well.

I'm suggesting that the time of largesse by the United States is over because it's a largesse at the expense of the American consumer. So if we're going to restrict, we ought to put on the quota and then the revenue goes to the U.S. Government. If we need a quota or if we put a tariff on it goes to the U.S. Government immediately. If we put on a quota, we can auction that quota and the revenues can also go to the U.S. Government.

I've heard that the U.S. Government needs some revenues so it might fit in nicely.

Mr. STOKES. It must be a rumor. I don't know if it's true or not. Congressman Obey.

Representative OBEY. Well, I have a question and then a closing comment.

First of all, Professor Colbert, you made reference to the fact that you were not an economist. I recall being at an NFO meeting—for the uninitiated, that's the National Farmers Organization—meeting in my district some time ago and I heard one of the speakers at that conference make the observation—well, he asked the question—he said, "Did you know that if you took every agricultural economist in the world and laid them end to end, that it would be a good thing?" [Laughter.]

That's the attitude in the small towns of my district any time you start talking about the realities of international economics as opposed to the realities they can see in their own community. And I think it's understandable.

Mr. Naya mentioned aid fatigue and Bruce in his introductory remarks indicated that we would be talking about the challenges in developing policies.

I wear another hat around here as chairman of the Subcommittee on Foreign Operations of the Appropriations Committee and, there, we face the challenge of development of policy, and I'd simply like to be the devil's advocate—I think I know what the answer will be, but I would nonetheless like to get them on the record for later use because frankly when Members of Congress go around, whether they're talking to Main Street businessmen or whether they're talking to farmers or whether they're talking to their local Rotary Club, the question that will often come up, especially in light of what some of you have said today, is this: "Since we are going to be experiencing so much competition from these countries, especially the ASEAN countries, okay, Congressman, you tell me why, under those circumstance we should be providing any aid whatsoever to those countries?

Outside of the considerations already mentioned by Professor Colbert, I'd like to for the record have the answers of each of the other three panelists in terms of why it is in our economic interests to continue assistance, assuming you think it is. If it isn't, say so.

Mr. **Naya**. I think I mentioned that these countries have to face the fact of not only aid fatigue, but debt fatigue. This really means that they have to raise more resources internally. In fact, if you look at capital inflow into the countries we have been talking about, you find there is a lot more private capital going in. The aid component has become very small except for a few countries like the Philippines and a few others that were obviously emergency cases. I'd like to see more private capital inflow into these countries. In that sense, I was using aid fatigue and debt fatigue.

Representative **Obey**. I understand that, but if you look at it in the sense that I'm asking the question, what is the answer to the average American on the street who asks the question, "If these countries are competing with us and if we're running a trade deficit with them, why don't you birds in Washington cut off all aid? At least we don't contribute to the problem." That's the way I get the question.

Mr. **Naya** In writing the statement, I was very surprised to find how well we have done in these countries. As I mentioned, this is the only area in the whole world we have done quite well.

Representative **Obey**. But my question is, is it in our interest to continue providing aid for any economic reason that you can think of?

Mr. **Naya**. In the case of the Philippines, yes I believe the survival of the Philippine economy and its political system at the moment depends on American aid, as well as Japanese aid.

Representative **Obey**. Any others?

Mr. **Krause**. I would just add that the income figures that Mr. Naya quoted about Indonesia also indicate that it is not a rich country and that aid is part—not a very large program really from the United States—but it's an important part that adds things that we uniquely can provide, and it's in the U.S. interest in the longer run.

Of course, when countries get rich and they are competitive on their own, they should not get aid.

Representative **Obey**. What I want you to put in the record is why is it in our interest economically, not why is it good for them, why do they need it, why is it the humanitarian thing to do. But why is it in our own economic interest to do it?

Mr. **Krause**. I think you have to stand back and start from our more fundmental interests in terms of security, stability, and progress in that region. That is in our interest because it prevents wars and Americans from being killed in Asia. In fact, replacing the needed American military expenditures if their societies become strong and viable in their own terms and can handle their own defenses.

Representative **Obey**. But do you see any economic reason for us to continue providing aid? That is one of the justifications we get all the time.

Mr. **Krause**. Well, the concept that a rising tide raises all boats is true for countries that are complementary to the United States and countries like Indonesia in this stage of their development are complementary. When they grow faster, they do buy more from the United States and that's the point that Seiji Naya is making—that in fact the experience shows they do buy more from us. They are good customers and that's why helping their economy within economic terms alone is beneficial.

Representative **Obey**. All right. That's what I wanted you to get on the record.

I'd like to ask Mr. Krause one other question. You indicated that we needed to get to about $60 billion in terms of the Federal deficit. We have had other economists testify who indicated that if we can get it down to the range of $100 billion it would be satisfactory.

How do you come up with the figure $60 billion?

Mr. **Krause**. Well, that's my judgment when you look back to the budget deficit when the United States was in balance-of-payments equilibrium. It was in the nature of about $40 to $50 billion, and I'm using an inflation adjustment from the latter 1970's to now.

Now this is a ballpark figure because in fact it presumes that the inflation rate of the GNP deflator in the United States continues very low up to when we get down to $60 billion, and that would be current dollars at that time.

By no means is that a precise estimate. I think the point is that there's just a lot more to go from where we are now.

Representative **Obey**. Let me make an observation in closing, Professor Colbert asked the question, in effect, if the countries, especially the ASEAN region, are squeezed economically, what are the consequences to us?

I think that's a legitimate question and I certainly think it's an important one for us.

But as a practicing politician, I think we have to remember that the U.S. populace reacts the same way, not just policymakers but the general public. And I sense a tremendous concern on the part of all of the participants and a good part of the audience in terms of what actions might be taken on the trade front this year. I think it's understandable that this is happening.

We've had a lot of people explain today why things are happening in Japan and why things are happening in some of the other countries under discussion.

I think the reason you're getting that popular concern expressed in this country that we ought to take action on trade that many in this room would not like is simply that we have seen that most families in this country really haven't had any real increase in income since 1973 when a study was done for this committee which we released earlier in the week suggested that two-thirds of the new jobs created in this country since 1980 paid less than $7,000 a year.

If that study is accurate and correct and if you add it to the other considerations that average families are facing in this country, they are bound to want action to be taken by somebody. And I think the facts are that if the budget deficit is not fixed and if that results in a trade deficit and that results in countries demanding that we take action on trade, it's inevitable that Congress is going to take action, some of which will probably not be wise.

And I think if the administration wants to avoid destructive action on the trade front as far as the Congress is concerned, that it is not enough to send Mr. Darman out to attack the quality of American business decisions, although I certainly grant the accuracy of some of his remarks. I think we need to drop the theology that has been draping a lot of economic decisions in the past 2 or 3 years and I think we have to have support on the part of the administration for a balanced attack on the deficit and if the administration is not willing to include a revenue component in that attack on the deficit, then I think they invite the consequences, one of which will be a congressional attack on symptoms simply because they are precluded and being blocked from attacking the disease itself.

And that is regrettable but it's a political fact of life that I think we face. And so I would suggest that to the extent that people in this country are concerned about irrational actions that might be taken on trade, it would be helpful if you could help convince the fellows who run the little White House at the other end of the avenue that we've got to have some other direct actions taken on the budget front which might offend their theology but which might get our own house somewhat more in order.

Tomorrow we will resume with the last panel with a discussion on China. Let me thank every member of the panel for appearing today, I appreciate it. I certainly appreciate Mr. Stokes' willingness to serve as moderator for the activities this afternoon. Thank you again very much. [Applause.]

[Whereupon, at 4 p.m., the committee recessed, to reconvene at 9:30 a.m., Friday, December 12, 1986.]

SYMPOSIUM ON U.S.-PACIFIC RIM RELATIONS

FRIDAY, DECEMBER 12, 1986

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to recess, at 9:30 a.m., in room SR-325, Russell Senate Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representative Obey.

Also present: Richard F. Kaufman, general counsel; and Don Terry, Democratic staff director.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. Good morning. As I think everyone here knows, this is the second day of a 2-day conference on the economics of the U.S. relationships with Japan and other Pacific Rim countries and trading partners.

If I could just take a moment to sum up what we talked about yesterday before moving on to today's panel, yesterday it was pointed out that after World War II the United States pretty much sat astride events in the world, both political and economic.

Since that time, we have seen an amazing transformation of Japan, for instance, from a country decimated militarily to the second most powerful economic force in the world today, and some feel that by the year 2000 it may well be the leading economic force in the world.

We discussed Japan as both a competitor and a market. We discussed changes in our economic relationship. We discussed the emergence of Japan as a center of capital and the United States as a center of debt.

We discussed the emergence of other economic players in Asia. We discussed the need for change on both sides of the Pacific in terms of the way we approach our economic strategies.

We discussed the need for Japan and others, but most especially Japan's reliance on exports as an engine of growth and their obligation to assume a greater role in facing economic problems of the world's economy.

We discussed the need of the United States to get into shape competitively in both the private sector and the public sector. One panel unanimously suggested that the most important action which the United States could take to improve our own trading posture would be to get our deficit down to less damaging levels.

Many people yesterday also expressed concern that Congress in addressing our trade problem might not face the fact that deficit reduction can do more than can adoption of reckless trade actions to deal with our trade problem.

In response to that, yesterday I observed that a number of witnesses had expressed tremendous concern about—well, let me put it a different way. A number of witnesses had gone out of their way yesterday to explain why a number of other countries perhaps could not do as much as we would like to see them do to reshape their economic strategies in a rational way because of indigenous political pressures on those governments and on those players.

In response to that, as a practicing politician on this side of the ocean, I tried to describe what some of the realities are that place those same kinds of limitations on our own political policymakers.

I tried to make this point: that we have seen in all practical terms the effective purchasing power for most American families in this country remain essentially constant since 1973. In fact, the Joint Economic Committee published a report done for us by two economists just this week which suggested that in the last 6 years two-thirds of the new jobs created in this country paid $7,000 a year or less.

It has been the traditional view that those who are getting hurt most by the lack of effective job opportunity in this country are minorities, young workers, women, and that certainly is true in many respects. But the study which was presented and which we released this week also pointed out that there are 1 million fewer jobs that pay $28,000 a year or more held by white males than was the case in 1980. And that I think indicates why, when many of us in the Congress go home to our districts and our own communities, we feel this general sense of frustration expressed by people who feel that their room for economic opportunity is really being squeezed.

To put it in perspective here, I could cite just one fact. The average 30-year-old male worker in this country in 1960, the year that I graduated from college—that average 30-year-old worker on average 10 years after he had left the family nest and had been out on his own was making about 30 percent more in real dollar terms than that young person's father had been making when the kid had left home. Today, that same 30-year-old worker on average in real dollar terms is making about 10 percent less than his father was making when he left home 10 years earlier.

The years during which we expand our income in our lives in this country by the greatest degree are those years between 25 and 35. We have seen that in 1973 the average 35-year-old worker had expanded his income by about 115 percent in real dollar terms over the previous 10 years. In contrast, as of last year, that same 35-year-old worker in today's economy has experienced real growth in income of only about 15 to 20 percent.

That is a significant change and I think it demonstrates that there are tremendous pressures in this society based on people's real economic situations, tremendous pressures on this society as well, which sometimes make it difficult to get Government to do what needs to be done.

I also made the observation yesterday that if we are concerned about Congress—we were given three choices yesterday by one of the panel moderators. The moderator asked each of the panelists what's the most important thing for the United States to do to get its corporations, get its work force in decent competitive shape, attack the Federal budget, or take action on trade? As I said, most people said to attack the deficit was more important and expressed great concern about how Congress might deal with the trade issue.

And the point I tried to make is that, desirable though that might be, it may be very difficult to have the deficit rather than trade become the focal point of activity in this town unless we have a great degree of cooperation between the executive and legislative branch of Government.

What I tried to suggest yesterday is that if the budget deficit is not fixed because of an adherence to ideology which does not reflect reality, and if as a consequence the trade deficit continues to rise, and if as a consequence tremendous pressure arises for political actors in this country to take action on the trade front, then I think the administration is faced with the choice.

If the administration wants to avoid destructive as opposed to constructive congressional action on trade, it seems to me, as I said yesterday, that it is not enough simply to send Mr. Darman out talking about the lack of quality in decisionmaking in the American business community. Some of those criticisms are certainly accurate, but it is not enough to do that.

We need to drop the theology and to support a balanced attack on the deficit. And in my judgment, if the White House and the administration are not willing to include in that attack on the deficit some revenue component which certainly does not have to include an attack on the middle class, but if the administration, for instance, is not willing to consider some actions on the revenue side such as those discussed by the new Speaker, Jim Wright, then I think they invite some of the consequences which people expressed concern about yesterday with Congress attacking the symptom because they are precluded from really attacking the disease.

I think that pretty well summarizes what we talked about yesterday.

Today, we turn to our relations with the giant on the other side of the Pacific, China. Some 25 years ago, when I was squirreled away in the carrels of the library at the University of Wisconsin as a graduate student studying the developing Sino-Soviet split, it was clear that some pretty profound changes in political relationships between the Soviet Union and the People's Republic of China were taking place.

What was interesting then is that, while those changes certainly seemed to be visible in the literature, you couldn't tell that those changes were taking place if you looked at U.S. Government policy because at least at the top U.S. policymakers seemed not to notice or seemed to dismiss the seams that appeared to be developing politically between the Soviet Union and the People's Republic of China.

And we did not seem at all prepared to explore the opportunities for the United States that those seams presented.

In the last decade, equally profound changes have been taking place in China, but this time the changes are not just political; they are also economic. I think that those economic changes may very well be just as significant as the political changes were 25 years ago and as some of the political changes are today.

We have seen rapid swings in policies being followed by Chinese authorities and so it's hard to say whether the economic departures in Chinese thinking will continue to be as dramatic as they have appeared to be the last 2 years, but certainly forces have been put in motion that most in the West did not see coming and did not expect.

I hope that this time around we will be fortunate enough and diligent enough to be more on top of policy developments in China. The People's Republic seems destined to play eventually a major role in reshaping the economic landscape of the Asian Pacific region and it's important that we all understand the directions in which that country is moving and prepare ourselves to respond effectively to whatever new challenges and opportunities are presented.

Today, we have another distinguished panel to explore that question with us and we also have a distinguished moderator. I would simply say that anybody who can both serve in Ronald Reagan's State Department for 3½ years and also work for Dave Obey at a different time has to be someone who has a great deal of talent in dealing with all kinds of characters in this town.

Alan Romberg is a terribly important national resource, in my judgment. He was a foreign service officer for 21 years. Much of the time he worked in China. He is now Senior Fellow for Asia for the Council on Foreign Relations. Before that, he worked on the China desk at the State Department and also dealt with the same issues in his work at the National Security Council and the State Department Policy Planning Staff.

He spent 3½ years as a spokesman for the State Department and Senior Deputy Assistant Secretary for Public Affairs at State. As I say, the least important of his activities but the most valuable to me were the 10 months that he spent wising me up on a variety of issues in the foreign affairs arena.

Al, why don't you take over and see what you can get out of this panel.

Panel 4.—Alan Romberg, Moderator

Mr. ROMBERG. Thank you very much, Mr. Chairman. I think that the committee, you and your staff, all ought to be congratulated on this series of panels. Personally having dealt not only with China but with Japan and having had the education of my experience on the Hill, I am very tempted to go back and comment on your opening statement about yesterday's panel. But I will forego that opportunity.

Clearly, as Chairman Obey has pointed out, this is a critical subject involving the United States and the People's Republic of China but much more than that. The question of U.S.-P.R.C. economic relations is not only a bilateral question and it is not only an economic question.

I think that when you hear from our panel today you will get a very rounded picture of the kinds of forces at work and the kinds of considerations which go into not only understanding what's going on today but what the likely trends will be in the future.

I should say I just returned a couple weeks ago from an extended trip in Asia, including 2 weeks in the P.R.C., and I was very impressed with the degree of dynamism on the part not only of the central officials but most particularly the provincial and local officials to move ahead with economic reform and indeed with political reform which they have now made clear they feel is necessary to underpin further economic progress.

So I will be anxious to hear what our speakers have to say as well.

My role here is really to be a traffic cop and so I will turn to that. Let me say before I introduce our panelists that I think the most effective way of handling questions would be if you would indicate to members of the committee staff by raising your hand that you have a question, they will have cards and you can put your questions on the cards and that will I think facilitate, if I read those out, everybody hearing what the question is instead of the usual problem in a setting like this where some people hear and some people don't hear what is being asked. So if you would do that as the session this morning progresses, that would be I think most efficient.

Let me then introduce our speakers. I am going to introduce all four of them at one time rather than one at a time and then they can turn to their presentations in order.

The first presenter is Nicholas Lardy. Nick is a professor at the Jackson School of International Studies at the University of Washington and director of the Chinese Studies Program there. I have a problem frankly of adjusting to that since my dealings with Nick came when he was at Yale and how Yale let him get away to go out to the West Coast I don't know, but it certainly was their loss and Washinton's gain.

He is one of the most respected scholars on China, and particularly on the Chinese economy, and he has published a couple of books, including "Economic Growth and Distribution in China" in 1978, and a book on "Agriculture in China and Modern Economic Development" in 1984, both published by the Cambridge University Press.

I think you will find that he has some interesting perceptive things to say about the Chinese economy this morning.

Allen Whiting, who is also a very well-known and respected scholar on China. Going back to my personal association with him—I don't know if he remembers back to when I graduated from college at the same time Dave Obey graduated from college and I wrote to Allen Whiting and said, "What should I do with my life?" And he, not knowing me at all, wrote back a three-page, single-spaced letter about it—a man who cares about not only the substance, which he does very much, but also about how people try to create their careers to be most productive.

Having been at the University of Michigan for many years and also having been in the Government working on China both in Washington and Hong Kong, he is currently professor of political science and director of the Center for East Asian Studies at the University of Arizona. His book on "Siberian Development in East Asia," was published in 1984 and also published in Japanese, but I also remember a book he published about Xinjiang several years before that and other publications.

Melvin Rines I have not previously known but having read his paper that he's going to present this morning, obviously a man of considerable background and experience on not only China but also some of the more difficult aspects of how one deals with a developing country.

He has over 30 years experience as an investment banker in public, corporate, and international finance; currently managing director, Kidder, Peabody & Co., and has coauthored major research reports for the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, and the World Bank, and I think that, again, you will find that he has not only a breadth of knowledge about China but also a grasp of some of the more difficult issues that face Americans as they are dealing with China today in terms of law, regulation, finance, and so forth.

Finally, another man of considerable talent whom I have known for a long time, Roger Sullivan, who is currently president of the National Council for United States-China Trade, a long-time foreign service officer with a great deal of experience on China, but also on a variety of issues which—perhaps not so tangential—but were not directly on the subject. For example, he was the political adviser in Hawaii to the Commander-in-Chief of the Pacific. He was on the National Security Council staff as the senior staff member dealing with China and East Asia. He was Deputy Assistant Secretary of State for East Asia and Pacific Affairs covering the area and was very much involved in the normalization process with the P.R.C. and also had been on the China desk prior to that.

So I think altogether we have an extraordinarily experienced panel and I think that without further ado I will turn the floor over to Nick Lardy. Each of the panelists will talk for roughly 10 to 15 minutes and then we will turn to questions.

STATEMENT OF NICHOLAS R. LARDY, PROFESSOR, HENRY M. JACKSON SCHOOL OF INTERNATIONAL STUDIES, UNIVERSITY OF WASHINGTON

Mr. LARDY. Thank you very much, Alan. I would like to thank Congressman Obey and the committee for inviting me to participate in this program on U.S. economic and political relations with China.

I would like to begin with a very brief summary of the dramatic transformation in China's economic performance in the last decade and then turn to issues such as the projection of how China is likely to do in the future in terms of its domestic development, its foreign trade, its ability to attract foreign investment, and then turn to the question of how well the United States might do in terms of competing in this growing market. Then, at the end, I will turn briefly to a few issues in U.S. economic policy toward China.

I will begin with a very brief background on the dramatic transformation that has occurred in Chinese economic performance since the beginning of the reforms in the late 1970's. I don't want to give a lot of statistical detail but I will just highlight a few key facts.

The most important of them, or course, is the fact that domestic growth has been extraordinarily high, in excess of 8 percent annually in real terms, which is about 50 percent ahead of the long-term of growth that had been achieved in the previous two or three decades. So there's been a great growth acceleration since 1977 or 1978.

Combined with that has been an even more dramatic surge in China's foreign trade. China's foreign trade has roughly quadrupled. Its standing in the world trading system has advanced enormously. It's gone from something like the 25th largest exporter to the 15th ranked world exporter in the course of only a few years.

Third, despite impressions to the contrary, I would say that China, compared to other developing countries, has been relatively successful in attracting a significant flow of direct foreign investment. It may be less than certain Chinese leaders had expected or than certain economic figures in China would have liked, but the flows of direct foreign investment going into China in 1984 and 1985, for example, were greater than those going into any other developing country. So there has been a very dramatic transformation of China's domestic economy both in terms of the growth rate, and in terms of its interaction with the world economy as measured either by trade flows of by capital flows.

It think one of the issues that we ought to look at is whether or not this dramatic pattern of transformation is likely to continue because I think it bears very heavily on some of the issues that Congressman Obey outlined at the beginning. In other words, I think it really will make a difference over the long haul how rapidly the domestic economy grows. It will have an effect in terms of shaping its interaction with the world economic system.

And my argument here is, in short, that unless the industrial reforms in the modern manufacturing sector become far more successful than they have been to date, we are likely to witness a downturn in the pattern of growth in the economy over the medium term. That is, over the next 5 years or so.

This is in part because the gains that have occurred in the last decade have been in large part generated in the argicultural sector. These gains are, by and large, one-time recovery factors resulting from the dramatic changes in institutional arrangements that have occurred. China still is a land-short economy and its farm sector is not likely to grow at anything approaching the rate it has grown over the past 7 or 8 years. Indeed, already in 1985 and 1986, we see the growth of the farm sector has fallen by about half. It's been growing in the last 2 years, that is 1985 and the current year, at rates of about 3 to 4 percent, less than half of what it had been able to achieve between 1978 and 1984. So the farm sector is already in transition to a substantially lower rate of growth.

So the question is whether or not there can be any offsetting gains in the nonfarm sector and here, of course, it may be premature to judge, but what we can see to date suggests little evidence of improvements in productivity in the manufacturing sector.

Indeed, productivity in manufacturing in the State-owned sector appears to have declined rather continuously since the onset of reform in 1978 or 1979. Perhaps there will be a turnaround, but there are major structural problems that I go into in the paper that I don't have time to talk about here which I think on balance lead me to be very cautious in predicting a turnaround in productivity and, thus, more rapid industrial growth.

So I believe the bottom line is that we can expect a somewhat slower rate of growth of the domestic economy over the medium term—not somewhat slower, but perhaps a decline of about 50 percent as compared to the past 7 or 8 years.

On the trade side, looking ahead, I am also relatively cautious. I think when one looks at the pattern of trade development over the past decade one has to recognize that it was achieved in part only by a massive current account deficit beginning in the second half of 1984, a deficit that is continuing through the first three quarters and probably through the entire year of 1986.

Even if China substantially liberalizes its borrowing policy and substantially increases its foreign indebtedness, it will not be able to sustain these trade deficits for more than another year or two at most.

So the key thing becomes their ability to promote exports and I think here, looking at the record, one has to be relatively cautions.

If you look, for example, at the increase that occurred in China's exports between 1981 and 1985, you find that about half of the incremental export growth can be accounted for entirely by petroleum and this was achieved by exporting almost all of the extra output that they were able to generate in those years. This is an unsustainable course because of shortages in the domestic economy and because of the decline in the international price of oil.

And I would suggest to you that the key problem for China really is to do better in decentralized exports, not the sale of primary commodities such as petroleum and grain, which has been another turnaround sector, and other primary commodities that they're selling in standardized, highly developed international markets.

What they have not been as successful in doing is moving ahead with decentralized exports of labor-intensive manufactured commodities where their comparative advantage almost certainly lies.

So the reform in the foreign trade sector I would say has to be much more successful before one can be optimistic about their ability to accelerate export growth.

So instead of the double digit rates—indeed, the rates of growth of exports in recent years have been more than 20 percent—I'm expecting rates of growth of exports much more on the order of 5 to 6 percent in real terms over the next 5 years or so, so a substantially lower rate of growth of trade expansion.

On the investment side, I think one has to begin, of course, by recognizing that even though China did attract a substantial amount of direct foreign investment in 1984 continuing into 1985, a process that really got underway in the late 1970's, that in 1986, that is this year, we have the first decline ever since 1979 in the flow of foreign capital in the form of direct investment into China.

The Chinese are taking steps to reverse this, but I think it's going to be a slow and arduous process. I'm sure that Roger Sullivan and others on the panel can comment on this in more detail, but my own sense is that the new provisions for encouraging foreign investment, which were announced by the Central Government in early October, are not likely to turn around this situation very rapidly.

I would argue that the center lacks the political will to issue the appropriate regulations. They certainly know what needs to be done to attract foreign investment, but they lack the bureaucratic clout to make these regulations stick in the provinces where most of the investment is going on.

To summarize, looking ahead, I think the rate of growth of the economy is going to slow substantially. The rate of growth of China's foreign trade is going to slow substantially, and the flow of capital into China will also slow substantially. And how much these slowdowns are will depend in large measure, in my judgment, on the success of the reforms in the industrial sector.

Well, let me turn to the third topic I'd like to touch on very briefly and that is, how well is the United States positioned to take advantage of this trade growth that's likely to occur in the years ahead. That is, even if it's a much slower rate of growth than has been the case in the past, how well are we likely to do?

I suggest we have to begin by letting the past serve as our guide. If you look, for example, at the last 5 years, 1981 to 1985, you find Sino-Soviet trade is up nine times, from a very low base admittedly. Sino-Japanese trade has increased by $6 billion. Sino-United States trade over this period has increased about 10 percent, about $1.5 billion.

In short, I tend to believe that Japan and the Soviet Union and to some extent the countries of Eastern Europe may be better positioned to take advantage of China's growing trade in the years ahead. Let me just say a few reasons why I think this is the case.

I will begin with the case of Japan, although again I'm sure we will have a more detailed view from Allen Whiting who has spent a great deal of time studying this in recent years. Japanese-Chinese economic relations are morbid by a growing complexity which is not evident in the case of United State-Chinese economic relations. I would point to two or three factors.

The Japanese have far and away the largest bilateral aid program to China. Their Overseas Economic Cooperation Fund has provided about $3.5 billion in concessionary credits to China. It rivals the World Bank as a source of soft loans to China. Although it's nominally not tied, about three-fourths or more of this aid is actually used to buy Japanese goods. The projects that are being supported are all keyed to generating sales of Chinese products in Japan. That is, they are directed toward development of energy, ports and transportation, all of which have the long-term objective of substantially increasing the flow of coal, for example, into the Japanese markets. So the Japanese are making investments that are going to allow the Chinese to export more to their market which, in turn, will enable the Chinese to buy more from the Japanese.

Of course, the United States has no aid program to China, so there is no counterpart in terms of this dimension of the Japanese-Chinese economic relationship.

Second, the Japanese are also the largest supplier of credit to China. Through their Export-Import Bank, they have supplied over $2 billion since 1979 in highly subsidized loans. Again, in contrast with the United States, it's striking. The U.S. Export-Import Bank is almost irrelevant today. Their interest rates and their commitment fees are so high that they are not competitive with the Japanese and other national export-import banks. The result is, the amount of trade that has been financed through the Export-Import Bank in terms of United States-China trade is extraordinarily small.

I know U.S. policy in this regard is to try to talk other countries into reducing the degree of subsidies provided, but I think in the short run this is a policy of folly. It has not worked and, in my judgment, is not going to work.

If you look—continuing on the credit side—not only Export-Import Bank loans, the Chinese have also raised about $2.5 billion now on international capital markets. About 80 percent of this has been raised in Japan. Again, there is no U.S. counterpart. It's unlikely that the P.R.C. is going to raise money in U.S. financial markets for a variety of reasons we can go into later.

So in terms of those three dimensions—the aid programs and credits, including the bond market—Japan is simply far ahead and better positioned than the United States to take advantage of the China market.

I'd say, third, they have made substantially more investments—and by this I don't mean direct foreign investment but expenditures to understand the market. Government-sponsored research on the Chinese economy is far in excess of what we have in the United States. There are private and quasi-private efforts underway in Japan and I would say that they dwarf the efforts of the United States counter-part institutions. The details of this are spelled out in the paper. I don't need to go into at this point, but the Japanese simply have made much more effort to understand what's going on in the China market. I think the remarks by Congressman Obey yesterday morning at the opening session in which he related a vignette about how effective the Japanese have been I think are just one example of the kind of thing the Japanese have done.

And on the private side, Japanese firms have done much more as well. They have a much longer time perspective. This comes to one of Allen's points. They have five times more registered representatives in-country in China then do United States and they are very broadly distributed, unlike the United States case where almost all of our representatives are sitting in Peking hoping for something to happen.

I think the net result of this is that Japanese firms are the best informed of all foreign firms on developments in China and they have been positioned to take advantage of this quadrupling of Chinese trade that I mentioned at the outset.

The result has been a huge rise in the importance of trade with China for Japan. A number of years ago, China was about eighth most important trading partner of Japan. By last year, they were Japan's second largest trading partner. This is an extraordinary transformation and, again, the contrast with the United States is striking.

We have not made the investments. We have abolished the only office in the U.S. Government that had a capacity for long-term research on the Chinese economy. We have failed to fund many of the important protocols that would have provided information on the workings of the Chinese economy.

The result is that bilateral trade between China and the United States is, quite frankly, miniscule. It's 1 or 2 percent of our total trade. China is our 16th ranked trading partner after Canada, Japan, Mexico, almost every country in Western Europe, South Korea, Taiwan, Singapore, Hong Kong, Brazil, and Venezuela. And this situation, in my opinion, is unlikely to change under current policies.

So I think the Japanese have captured more of the market. They have made the investments that suggest they will continue to be able to capture more of the market than the United States.

Let me just say something very briefly about the Soviet Union. Again, this is spelled out in greater detail in my paper.

Sino-Soviet trade has increased tenfold between 1981 and 1986. It's up about 60 percent more in the first three quarters of 1986, a period of time in which Sino-American trade has been up only 10 to 15 percent. And if the present trends continue—and I'm not necessarily projecting they will—but if the present trends continue, Sino-Soviet trade will surpass Sino-United States trade by 1989 or perhaps 1990.

Now is there any basis for thinking that these dramatically different trade trends will continue? After all, this is simply a straight-line extrapolation based on rates of growth over the past 4 or 5 years that may not continue.

I would say there are several factors that suggest that Sino-Soviet trade will continue to grow at a fairly high rate. They have signed a long-term trade agreement that calls for substantially more trade. There's some dispute about exactly what the figures are. The second agreement which was signed this fall has not been made public so I'm a little bit unclear what the numbers are, but the most recent Chinese sources I've seen say that the total trade over this 5-year-plan period from 1986 to 1990 is going to be in the neighborhood of about $30 billion. When they signed the first agreement in 1985 they said it was going to be $14 billion. So their expectations have doubled over a period of about 14 months.

Second, the Soviets have agreed to supply substantial technical assistance to China, both to modernize some of the plants that they developed in China in the 1950's and to develop some new plants.

Third, they have opened border trade a couple years ago after a 20-year hiatus, and border trade is growing very very rapidly, both in the northwest in Xinjiang and also in the northeast. So there's been a substantial increase in this trade.

Fourth, the Chinese have made substantial investments to increase their transportation capability to the Soviet Union. The only rail line to the Northwest, construction of which was suspended at the capital of Xinjiang in 1960, is now being extended to the border of the Soviet Union and will link up with the main Soviet line.

It is said by the Chinese that the pace of construction of this particular line exceeds that of any rail line developed in China since 1949. So this is going ahead as a very high priority project. There have been other improvements in the transportation infrastructure in the Northwest as well.

Finally, I would point out that the Chinese have in the last couple years very substantially reoriented their regional development policy. The areas in the northwest, to some extent even part of the northeast and into Mongolia as well, have been directed to reorient their economic development policy to turn to the Soviet Union for increased trade relations and general economic integration. In other words, instead of trying to continuously orient their economy toward the coastal part of China, they are being told that the rational strategy to pursue is one of economic integration with the Soviet Union, much closer in terms of transportation and other costs, than trading with the core areas of China that are more developed.

So for all of these reasons, starting with the agreement and going through regional development policy, I think it's likely that the Sino-Soviet trade is going to continue to grow very rapidly.

I don't think this is necessarily a bad development from the point of view of the United States. Indeed, you could make the argument—I'm not going to make it—you could make the argument that it should be welcomed. But I think at a minimum it's something that deserves much closer analysis and I thing we should discuss its sources, its causes and its implications for U.S. policy.

Let in my closing minute or two talk a little bit about U.S. economic policy toward China. I would say most importantly we've had no consistent economic strategy toward China. We have viewed China variously as a possible counterweight to Soviet military power in East Asia, as a vast untapped market, as a socialist country that we might somehow to induce to enter the capitalist world system, and I think increasingly recently we have viewed it as a nonmarket economy that may have substantial tariff and nontariff barriers to U.S. products.

I think each of these premises or each of these fundamental bases suggest a different set of economic policies toward China and I think the problem is that we have been shifting among these over time over the last decade or so, and I think the result has been that we have been caught offguard by competition with China in third country markets. We have lost not only huge grain sales directly to China but we have lost huge grain sales to Japan, South Korea, increasingly the Soviet Union. We've lost soybean sales in Indonesia. We've lost cotton sales throughout Southeast Asia as a result of the fact that China has become a major exporter.

I think we are likely to face increasing disruption in trade relations with China in the future. I think the absence of a decentralized trading system in China with convertible exchange rates where most foreign trade still is carried out through foreign trade corporations which are government monopolies which operate under quotas—in other words, they must meet certain export targets regardless of the domestic resource cost of selling in the international market—suggests that we are likely to have an increasing number of cases in the years ahead of dumping and so forth that are coming before the International Trade Commission. I think we are going to face problems of market access and so forth.

So I think the central task before us really is to decide how we are going to treat China. My own personal view is that we have tended to put far too much weight on the possible strategic counterweight to the Soviets which has suggested one set of policies. I think we ought to develop a set of economic policies to provide a consistent basis for interaction with China. I think that's where the Chinese priorities lie, not in the military relationship that we have been pushing increasingly over the last two, perhaps three, administrations. Thank you very much.

[The complete statement of Mr. Lardy follows:]

Economic Relations between China and the United States

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Summary

I. China has undergone an extraordinary transformation both in its domestic economy and in its relations with the world economy in the post-Mao period.

1. Domestic growth has been extraordinarily high, in excess of eight percent annualy in real terms, about half again as high as the long term rate.
2. China's foreign trade has more than quintupled, advancing its standing in the world trading system remarkably from the 25th ranked to the 15th ranked exporting country in the course of a few years.
3. Despite impressions to the contrary China has been quite successful in attracting direct foreign investment, the flows into China in recent years have surpassed those of any other developing country.

II. Unless domestic reform of China's industrial system becomes far more successful than it has been in the recent past the pattern of China's growth and interaction with the international economy will be significantly modified in the next decade.

1. Domestic growth will slow significantly as the once-for all sources of growth of the recent past are exhausted.

2. China's ability to sustain export growth will be eroded and the rate of growth of foreign trade will decline sharply since foreign exchange reserves already have been largely exhausted and even substantially increased international borrowing will not be sufficient to finance more than two or three years of continuing current account deficits.
3. Direct investment in China is likely to slow to a small fraction of the trend in the past few years.

III. The major beneficiaries of increased trade with China in the medium term are likely to be Japan and the Soviet Union, not the United States.

1. Japanese firms, quasi-governmental organizations and the Japanese government have made substantially greater efforts to understand the Chinese economy and develop commercial relations than has the United States.
2. Not only has China advanced in the course of only a few years to become Japan's second largest trading partner, Sino-Japanese economic relations evince a growing complexity that has no counterpart in the Sino-American case.
3. China's difficulties in expanding their exports in

> the world market, due both to the limited success of industrial reform and increasing protectionism in the United States and Europe, are leading to an ever closer economic relationship with the Soviet Union. Sino-Soviet trade volume may surpass Sino-American trade volume before the end of the decade and we are likely to witness significant Sino-Soviet cooperation for the exploitation of Siberian economic resources.

IV. U.S. economic policy towards China has not been consistently formulated over time placing the United States at a relative disadvantage visa vis our competitors.

Introduction

China's economy and its foreign trade have grown unprecedently rapidly in the post-Mao period. National income, on the Chinese measure, more than doubled in real terms between 1977 and the end of 1985. The average annual rate of growth in this period was over eight percent annually, almost half again the long term rate achieved from 1952 to 1977. Similarly, China's total trade turnover, measured in U.S. dollars quintupled from less than fifteen billion U.S. dollars in 1977 to almost seventy billion dollars in 1985, again a rate of expansion that is several times China's long term trade growth. During this period bilateral U.S.-China trade rose from under three hundred million to more than seven billion dollars.

Finally, eschewing its past practice of financial self-reliance China has initiated significant foreign borrowing and has welcomed direct foreign investment for the first time since 1949. Although the commitment of foreign capital to China may be less than some leaders in China envisaged, the flow of foreign direct investment into China in 1984 and 1985 appears to have been the largest experienced by any developing country.

If these rates of expansion were to continue over the next decade China would still, by the standards of the World Bank or other international organizations, be a relatively underdeveloped country in per capita terms, with output of little more than four hundred U.S. dollars per capita, assuming that population growth continues at the 1.2 percent rate experienced in 1981-85. More dramatically, by the middle of the next decade total trade turnover would approach three hundred billion dollars, and China would probably rank among the world's four or five largest trading countries.

The implications of a two hundred billion dollar increase in China's total trade, for specific country and product markets would be substantial. The world would have to absorb, in increased imports, the equivalent of three times the exports of South Korea or Taiwan in 1984, almost four times the exports of Brazil, or more than half the exports of West Germany or Japan.

Since the great bulk of these increased Chinese exports, for reasons explained below, would be labor intensive manufactured goods and perhaps increasingly consumer electronics, the potential for market disruption is considerable. Weighed against that of course would be a huge increased market for goods of the United States and other western countries in China. The economic benefits of trade expansion to our own economy and to the world economy would probably far outweigh the economic costs of shrinking domestic production of labor intensive manufactured goods in the United States. The relevant question of course is whether the United States could tolerate the political costs that such an accelerated structural adjustment would entail.

A Look Ahead: The Prospects for Growth and Trade

There are at least four reasons, however, that call into question the validity of the type of projection that I have presented for China's economic, trade and investment position. First, and perhaps most fundamentally, only a handful of other countries during the process of economic development have been able to sustain, for a period of two decades, the rates of growth of output and trade, that China has achieved over the past nine years. One would have to make the case that China will somehow be another exception like Taiwan or Hong Kong and be able to sustain what Brazil and other exceptionally successful developing countries could not. China would have to equal the exceptional experience of the newly industrializing countries of East Asia to achieve the projections I outlined at the outset. In short international experiences does not suggest that China's exceptional performance in 1977-1985 can be sustained.

The Farm Sector

Second, much of China's exceptional domestic growth in the post-Mao period is due to the unprecedented spurt in growth of farm output. Between 1977 and 1985 agricultural output, in real terms, roughly doubled. There are two ways of putting this in perspective. First, the average annual growth rate over the 9 year period was almost three times the long run average rate of expansion achieved from the mid-fifties to the mid-seventies. Second, in terms of value-added agriculture has never contributed a larger share of the growth of national income in post-1949 China than it did in the most recent years. This is an astounding accomplishment since the economy in this period is very heavily industrialized compared to the 1950s.

For a host of reasons this spurt of growth is coming to an end. In large measure the gains in output achieved since 1979 reflect one-time gains associated with relieving the grossest inefficiencies, including the lack of production incentives for the individual farmer, that the state imposed on China in the Maoist era, particularly during the Cultural Revolution decade from the mid-sixties to the mid-seventies.

While the rural reforms have been enormously successful in releasing the constraints that previously held farm output far below its potential, in their present form they do not provide the basis for sustained agricultural growth.

Most critically investment in farming is too low, depriving the farm sector of the potential for future growth. As a result irrigation systems, the crucial basis for the sustenance of China's highly intensive farming system, have deteriorated.

Since the widespread adoption of the household responsibility system, the state is no longer providing adequate funds for irrigation and other farm investment; the collectives, which once allocated a significant portion of their net earnings for reinvestment, are far less significant units in the countryside and no longer mobilize significant investment resources; and increased private farm income is allocated overwhelmingly to one of three areas: increased private consumption; new and improved private housing; or increased holdings of savings deposits. Private farm investment including land improvements, purchases of machinery and other farm equipment, and the construction of fixed assets is quite modest. State investment in agriculture has never been lower, falling to an all-time low of 3 to 4 percent of state investment this year. The total investment in farming, from state, collective and private household sources in recent years has been more than about seven percent of value-added in farm activities, an amount that, if sustained, is unlikely to generate over the long run an expansion of farm output of no more than two to three percent, about a third the rate of recent years.

Some elements of the Chinese government, of course, are not unaware of that problem and numerous policies have been adopted since 1983 to provide increased incentives for private farming investment. But even if these efforts are successful or, alternatively, the state steps up its own commitment of funds to agriculture, the rate of growth of farm output is unlikely to approach that of 1977-1985. The fundamental restraint remains a shortage of arable land. Arable land per farm worker has fallen steadily since the 1950s and is now among the lowest in the world. Inputs that are, in essence, a substitute for land, notably chemical fertilizers, are already utilized at quite high rates and their increased levels of usage do not appear to provide the basis for future growth.

Other problems which can likely be addressed in the long run, will also hold down the rate of growth of farm output. First, is a critical shortage of all forms of energy. Electrification of the countryside appear to have made little progress in recent years. As recently as 1979, one-half of all farm households had no electric power. Among those villages that are "electrified" supply of electricity is quite frequently limited to a few places in the village and rationed in quality as well. Similarly supplies of diesel and gasoline fuel are quite limited. Since fuel to operate most tractors and so forth is sufficient only for about one-half hour of operation per day the huge stock of farm machinery is vastly underutilized.

Second, the rural transportation infrastructure is grossly insufficient to support a significant further move away from self-sufficient local agriculture. In the early 1980s as many as half of all of China's villages were not linked to any existing road system. Even villages nominally linked to the road system have access only to unimproved dirt or low quality roads frequently seasonably unusable. China's rural road network is less than half that in India, another low income developing country with a large farm sector. Finally the availability of trucks in the farm sector is extremely limited. In 1984 there was only one truck used in agriculture for every thousand farm laborers. In short, without substantial additional investments there is no basis for China's evolution toward a more market oriented agriculture with efficiency gains that further marketing and specialization would generate. Moreover, investments in rural infrastructure continue to lag. In the current five-year plan, covering the year 1986 through 1990 the Chinese propose to add only twelve thousand kilometers of highways, a relatively modest addition to the current system.

To summarize, the spurt of agricultural growth in 1977-1985 was largely a one-time recovery phenomena. Although releasing the restraints on agriculture, the reform does not provide the basis for sustained agricultural growth. Even if incentives were sufficient to stimulate substantially increased private investment in farming or the state itself decided to raise budgetary investment allocated to agriculture, the pace of development of agriculture will almost certainly fall. The shortage of arable land precludes easy sources of agricultural growth and neglect of infrastructure investment in farming can be corrected only over a period of many years.

If this analysis is even close to the mark it suggests farm growth will decline significantly, and unless there are offsetting changes elsewhere, that the Chinese economy will grow much more slowly in the medium term than it has in the past decade.

Prospects in Manufacturing

A third reason to doubt the optimistic projections of the opening pages of my paper is that there is not yet an adequate basis for believing that the reforms in the urban, manufacturing sector of the economy hold the promise of substantially increased productivity in industry. If urban reforms were even remotely as successful as their rural counterpart China's economy could weather the downturn in the growth of farm output with many fewer problems. Given the relatively large share of manufacturing in China's gross national output increased productivity there might easily more than offset the declining rate of growth of farm output.

Yet, at least in the predominate state-owned sector of manufacturing there is not yet much evidence of improved productivity that could serve as the basis for more rapid growth. According to calculations of the World Bank total factor productivity in state run industries actually fell almost ten percent between 1978 and 1982. Extending their analysis through 1983 with more recent data shows a very slight upturn but the level remains well below that of 1978.

Of course, it may be naive to expect the urban reforms which were initiated somewhat later than agricultural reform, to have such a rapid payoff. Perhaps the upturn in productivity in 1983 will persist and even accelerate.

While this can not be ruled out there are several reasons to believe that urban reforms are likely to be less successful than their rural predecessor: the vastly different role of prices in the two sectors; the lack of competition in the industrial sector; the combination of administrative and market oriented reforms, which has quite adverse consequences for industrial development but which has little effect on agriculture; and the vastly differing costs of capital in the two sectors.

Agricultural prices differ fundamentally from those in industry in three respect. First, and most important, agricultural production units, whether the collectives of 1955-1980 or the households of the early 50s and the 1980s, have never been subsidized by the state and have thus retained substantial sensitivity to the prices of their products and the prices of inputs they purchase. In short, the incomes of farmers have depended on their success in maximizing the difference between the value of their output and the cost of their inputs. Second, prices of farm output have generally been readjusted upwards so that they cover average production costs. Acute crises have ensued when this has not been true, as in the mid-1970s, leading to rapid remedial action, as in the case of the major adjustment of agricultural procurement prices begun in 1977. Third, the state has adjusted the relative prices of various agricultural products in order to induce the desired output mix. That was most obvious in the early 1950s, the early 1960s and since the mid-1970s. Only in 1966-1977 did the state forgo the adjustment of relative prices and rely almost exclusively on bureaucratic commands to influence the output mix.

In industry, by contrast, the price structure was fixed in the early to mid-1950s without any consideration for its effect on resource allocation. Raw materials and intermediate goods were assigned low prices so that the profits of state-owned enterprises, the source of more than 90 percent of state revenues, would be concentrated in the final stages of the production process. Raw materials and intermediate goods were increasingly distributed through the system of material balances so underpricing them did not necessarily lead to excess demand. The output mix of final goods, particularly after the completion of socialist transformation, was to be determined by the annual planning process, not by the decisions of profit maximizing enterprise managers. Second, once the price system was in place there were few subsequent adjustments. Reform of the industrial price structure was attempted in the mid-1950s, in the mid-1960s, and again in the early 1980s but with modest results. As a consequence of rising costs, notably for labor, in the late-1970s, as the industrial reform was getting underway more than one-quarter of all state-owned industrial enterprises could not cover their operating costs from their current revenues and depended on state budgetary subsidies to remain in operation.

In short, unlike in agriculture, the existing price structure in industry does not provide the basis for rational decentralized decision-making. Many, if not most, industrial prices reflect neither opportunity cost nor real resource costs. The price structure discourages enterprise managers from expanding the output of many products whose production entails a financial loss, but that are highly valuable from the point of view of society. Concomitantly the price structure encourages enterprise managers to excessive production of overpriced goods that are financially profitable, but whose real value to society may be low or even negative. Finally, since managerial rewards are unrelated to profits and the flow of government subsidies is seemingly unlimited, there are no sustained incentives for enterprise managers to reduce costs. Thus even if the price structure could be magically corrected overnight, there is no assurance that managers would respond in the appropriate fashion.

The virtual absence of competition in the industrial sector is the second fundamental factor inhibiting improved efficiency in manufacturing. Absence of competition is reflected in barriers to entry, no systematic rules for exit via bankruptcy, and significant barriers to internal trade.

Entry to many lines of manufacturing activity is limited by continued state control of the distribution of a large share of the output of producer goods and limitations, discussed further below, on access to markets. Despite the diminution of the scope of the centrally-controlled materials allocation system, the share of producer goods that are distributed through market-like channels, the so-called producer goods trade centers, was only 10 percent in 1985. The difficulties in acquiring machinery and equipment and subsequently uncertainties in acquiring raw material and semi-finished goods must discourage enterprises from shifting their product mix.

Exit of inefficient producers from an industry is also not assured. There is no bankruptcy law, although one has been in the drafting stages for years. Even were the law to be promulgated it could only be implemented bureaucratically since a detailed investigation would have to be undertaken to discover the precise cause of financial losses in each money-losing enterprise. Many money losing enterprises may be burdened with artificially low prices for their final products. Others may be grossly mismanaged. But they are equally protected by the present system that provides government subsidies indiscriminately to both types of enterprise.

Third, local protection is rampant in China imposing enormous costs in inefficiency. The old Maoist ideal of each region and province developing a "fairly complete" industrial system is flourishing in the Deng era. The result is a surprisingly low degree of local specialization. Rather than produce a few products for a regional or even national market each locality attempts to be relatively self sufficient in manufactured goods. The result is many small plants, producing at far less than optimum scale. While costs may be higher and quality lower, a local market is frequently assured by a blockade on products from other, more efficient, regions. That problem has been particularly obvious in the 1980s in consumer durable production, but it exists for a broad array of producer goods as well. The recent World Bank study for example points out that the rising demand for bicycles has been met largely through the expansion of the number of firms in the industry. But the new entrants are smaller scale high cost producers. Their ability to sell high cost, frequently inferior products in local markets is assured by local protectionism. Sale of bicycles produced at lower cost but more distant existing plants is prohibited via trade barriers.

The contrast with agriculture is sharp. Under the present system in rural households, who hold long-term land leases, have virtually unlimited freedom to change their mix of output in response to changing prices and market demands. This is evident in the dramatic changes that have occurred annually since 1978 in the allocation of land to alternative crops and the reallocation of other factor inputs. Competition has intensified as restrictions on private marketing activity have been eased.

The third flaw of the industrial reform is that it has sought simultaneously to enhance the power of enterprise managers and provincial local governments. The experience of other socialist systems and of China in earlier reform periods suggests that this combination may lead to increased inefficiency. The expansion of the revenue sharing system in particular has provided enormous incentives for local governments to capture industries that generate significant "profits" which may, in whole or in part, be retained to finance local government expenditures.

That type of rent seeking, a source of inefficiency whenever government restrictions such as trade barriers or price controls give rise to rents, is particularly acute in China because the government imposed price structure has created enormous disparities in rates of "profitability" of different branches of manufacturing. The rate of return on fixed assets varies from as high as 91 percent in food processing to as low as 3 percent in coal mining. The scope for local initiative is greatest in processing agricultural products since the inputs are less subject to central control than, for example, petroleum refining.

Many regions that once shipped their products elsewhere for processing have sought to build their own processing facilities in recent years, particularly when they are allowed to retain a substantial share of the "profits" that invariably are generated when the final goods are somewhat overpriced and the major raw materials, agricultural goods, still somewhat underpriced. One example of this type is cigarette manufacturing, one of the activities included within the scope of the "food processing" industry.

The phenomenon of localized rent seeking is clearly recognized as a major flaw in the current institutional arrangements but there is no clear strategy yet developed to address this problem. Zhao Ziyang's "Report on the Seventh Five-Year Plan," presented this spring at the Fourth session of the Sixth National Peoples' Congress was particularly revealing on this problem. The sharply rising investment rate of 1984-85, with its attendant shortages and inefficiencies, was said to be due to the "random launching of new projects by localities and departments," a trend which if continued would make it "difficult to continue the ongoing reform of the economic structure." Localities were implored to "have the nation's interests in mind" and "strictly abide by and implement the state's macroeconomic policy decisions."

The fourth flaw of industrial reform is the significant underpricing of capital. At the outset of the reform it was widely recognized that underpricing capital was a major source of inefficiency, encouraging firms to utilize machinery and equipment inefficiently. It was the root cause both of firms acquiring assets that were little used and of the over extension of the investment front. Assets could be held at little or no cost to enterprises since their acquisition was financed by government interest free grants. New construction projects could be initiated even if there was little prospect of completing them on a timely basis since there was little cost of tying up huge amounts of capital in such projects.

More significantly the failure to price capital realistically meant that there was chronic excess demand for investment projects that could be contained if at all only through rationing, a process known as economic planning. But the absence of economic criteria to allocate investment meant that most of China's investment decisions were made through the same type of process through which public works decisions are made in the United States--political log rolling, graft, and corruption. But instead of this process applying to a small share of investment decisions it was pervasive.

While the incentive to use capital wastefully had existed since the early 1950s in China the incentive for waste was substantially enhanced in a little noticed reform initiated in 1967. Beginning that year locally controlled enterprises were allowed to retain their depreciation funds to finance extra-budgetary investment. Earlier these funds, which are a fixed percent of the original value of fixed assets, were remitted in their entirety, along with enterprise profits, to the state treasury. Since even enterprises that are losing money are allowed to treat these retained depreciation funds as a cost item covered by subsidies from the state treasury the incentive for an enterprise to expand its assets is substantial. This incentive to hold assets was enhanced in 1971 when the retention of depreciation funds was generalized to all industrial enterprises.

Despite brave talk, little fixed investment is financed by bank loans or by interest-bearing debt. An increased share of investment is financed through retained earnings, so-called extra budgetary funds. In principle enterprises might treat those retained funds as a scarce resource to be allocated according to economic criteria. But the current institutional arrangements do not lead to a socially rational allocation of these resources. In the absence of capital markets the only rational use of the funds is to expand further the fixed assets of the firm. For even if the social value of the output is zero the investment will generate financial return to the enterprise into the indefinite future.

In short the current system has, to a large degree, turned enterprises into asset maximizers. Fixed assets come to them at little cost and then generate a permanent cash flow in the form of retained depreciation funds over which the enterprise has considerable discretion. This flow is in no way connected with profits, meeting goals for cost reduction targets, etc. There are no incentives to allocate resources rationally and it is not surprising that we witness inappropriately capital intensive production processes and extremely slow growth of employment in state-owned industry.

The contrast between industry and agriculture is striking. Except for a modest provision of funds for large-scale water conservancy investments and funds for mechanization of state farms, peasants bear the full cost of investments they undertake. A significant share of these investments is financed by interest bearing loans from the Agricultural Bank of China. The relevant interest rates have actually been adjusted upwards sharply since the reforms began.

The conclusion of this analysis is that increased productivity in manufacturing will emerge only slowly, and as a result the industrial growth rate of 1977-1985 is almost certain to fall significantly. In short, increased growth in manufacturing is quite unlikely to offset declining growth in agriculture and we should anticipate a substantial reduction in the rate of growth of the Chinese economy over the medium term.

The Trade Outlook

At first glance China's experience since 1977 provides some basis for optimism in the prospects for export growth--exports rose by fifty-five billion dollars over this period, from fifteen to seventy billion U.S. dollars. Yet a closer analysis suggests a far less sanguine outlook. First, the slowdown in the economy overall, ceteris paribus, is likely to slow the growth of trade. The slower growth of the economy means a slower growth of export goods and reduced demand for import goods to satisfy either investment or consumption demand.

Second, a significant share of the growth of China's foreign trade in the past five years in particular was made possible only by running a very substantial current account deficit beginning in the second half of 1984. In 1985 according to Chinese Customs Statistics China's imports outpaced exports by more than fifteen billion dollars. Relative to each country's export earnings China's deficit was a several-fold multiple of the record United States current account deficit of 1985.

China's current account deficits of 1984-85 were financed by increased earnings from sources such as tourism and shipping; remittances from abroad; increased borrowing;

drawing down of previous accumulations of foreign exchange reserves, and increased foreign direct investment. Space constraints do not allow full examination of each of these elements. Foreign investment, for reasons explained in greater detail below, is likely, in my opinion, to grow more slowly in the decade ahead. Foreign exchange reserves are currently the equivalent of only a few months of imports and thus the possibility of a further draw-down should be regarded as only a very short-term expedient. Borrowing, of course, has been growing at an accelerating pace in 1986. But even if the Chinese should decide to very substantially liberalize their borrowing policy, say by increasing their borrowing to a level yielding a ratio of repayment to earnings of twenty percent, this would be sufficient to finance China's present (1985-1986) level of current account deficit for little over a year.

The implication of the above analysis is that China's foreign trade growth over the next decade will be almost completely dependent on promoting export growth.

Third, the growth of exports in 1977-1985 was in large part due to two special factors that do not appear to provide the basis for sustained export growth in the next decade--the spurt in farm productivity and little noticed developments in the petroleum sector.

The rapid surge in farm output has had highly significant efforts on China's ability to import western equipment and technology to support modernization. The farming failures of the Maoist era had led to substantially increased dependence, over a period of almost two decades, on imports of wheat and corn, edible vegetable oils, raw cotton and sugar. At their peak in 1981, imports of these five commodities absorbed more than nine billion yuan in foreign exchange, fully one-fourth of China's foreign exchange earnings from exports. By 1985 this dependence on imports had been very drastically transformed. Wheat imports had plummeted and a deficit in corn had become converted to a surplus and China had been, for the first time since 1960, a net exporter of cereals. Raw cotton imports had shrunk to almost nothing and China became a net exporter of cotton. Sugar and edible vegetable oil imports shrank significantly. Those changes allowed China to accelerate imports of manufactured goods and technology by about five billion U.S. dollars.

As has already been suggested above, agricultural growth will decline in the years immediately ahead and the result is likely to be that the growth of China's net agricultural exports will slow.

A second special factor explaining China's relatively strong export performance in 1984-85 is petroleum. Chinese oil exports began on a very modest scale in the 1960s and did not surpass a million metric tons annually until 1973. They passed ten million metric tons in 1978 and were on a plateau of thirteen to fifteen million metric tons in 1979-83. But in 1984 and 1985 exports grew rapidly to twenty-two and thirty one million metric tons, respectively. Earnings from petroleum exports in 1985, which included about six million metric tons of refined products in addition to thirty million metric tons of crude, were almost seven billion U.S. dollars, more than one-fourth of China's total export earnings. The increased petroleum exports in this period accounted for more than half of the increase in China's exports in the first half of the 1980s.

Yet, this surge in petroleum exports in 1984 and 1985 was achieved at a very high cost. It was possible to step up exports dramatically only by allocating about eighty percent of incremental domestic output to the world market. That allocation has a high cost domestically because of critical energy shortages in the domestic economy in both industry and agriculture. The gap between the demand and supply of electricity in manufacturing alone, for example, was estimated at about fifty billion kilowatt hours annually in 1983, causing industry to operate about one-fourth below capacity.

The export of such large amounts of petroleum cannot be sustained for two reasons. First, it is subject to increasing domestic criticism. Domestic critics are arguing strongly that China on economic criteria should be a net importer rather than exporter of energy and that the opportunity cost of domestic output forgone from export of petroleum far outweighs the value of the goods that can be purchased on international markets with the earnings from petroleum exports.

Second, China, like other oil exporting countries, is suffering from the sharp decline in the price of crude beginning in late 1985 and continuing in 1986. In response to the lower price, China announced it would cut its exports of petroleum by two million metric tons in the second half of 1986 in an effort to contribute to a firming of the world market price.

In short, a large share of the growth of China's exports was accounted for by expanded exports of primary commodities--oil and farm products. In the case of the former they were probably economically irrational, given the critical domestic shortage of energy. The latter are certainly not likely to be the long-term basis for export growth given China's acute shortage of arable land.

China's short term growing dependence on primary product exports reflects a more profound problem as well--the limited success of reform in the foreign trade sector. Most of the growth of exports in recent years has been in products that are under the direct control of the centrally managed foreign trade operations: petroleum and refined petroleum products controlled by the China National Chemicals Import and Export Corporation; cereals, rice, corn, soybeans and edible vegetable oils by the China National Cereals, Oils and Foodstuffs Import and Export

Corporation, and textile products, controlled by the China National Textile Import and Export Corporation.

This pattern indicates the very limited success of foreign trade reform. First, as already suggested these exports are by and large controlled centrally. In the case of petroleum the crude and refined products are produced by institutions under the direct control of the central government and the Center allocated a large share of the increased output to the Foreign Trade Corporation to sell on the international market. In the case of cereals, the state still has almost monopsony control of purchases of cereals in the countryside through the agencies of the Grain Bureau of the Ministry of Commerce. Again, the Center allocates part of the purchases to the relevant foreign trade corporation to sell on the international market.

By contrast one of the goals of the reform was to provide incentives to individual firms to sell products directly on the international market by passing the foreign trade corporations. By and large this kind of decentralized exporting, responding to changing international market conditions has not occurred. There are several reasons for this. One, the Center still insists that three-quarters of the foreign exchange earnings from those transactions be handed over to the Bank of China. The firms incentives are undermined because they control only one-quarter of the earnings and because the remaining share is paid to them in domestic currency based on an exchange rate that still, despite substantial yuan devaluations since 1978, substantially over values the domestic currency.

Second, because there has not been sufficient reform of the domestic price structure, many domestic manufactured goods are overpriced and they cannot be sold profitably even since the yuan has been substantially devalued.

In short, China has been most successful in increasing exports of primary products that are handled by central agencies. International markets for these products are well established obviating the need for complex marketing strategies. Unlike manufactured goods quality is not a key issue. Finally, petroleum and agricultural products are both substantially underpriced on the domestic market, assuring that their export is highly profitable from a financial point of view for the foreign trade corporations.

Investment Outlook

While, as noted above, China has achieved considerable initial success in attracting direct foreign investment in the first half of the 1980s, it is far from clear that China's institutional structure can be adapted sufficiently rapidly to sustain this flow. Many direct investments were made in the early years with the hope that many well known problems of the Chinese investment environment could be overcome. Early experience has now shown that these hopes were ill-founded. While many multinational corporations with large fixed investments will presumably stay in China in an attempt to recap at least part of their sunk costs, new entrants will be much more cautious before investing.

Several key factors constrain the flow of foreign direct investment into China. The most important constraint is the continued Chinese insistence that each venture involving foreign capital, whether a joint venture or a wholly-owned foreign firm, be self-sufficient in foreign exchange. That is the firm must earn enough from the sale of the product or service to foreigners that there are sufficient funds to pay the foreign firm a sufficiently attractive return on its investment. In practice this means that the Chinese do not really want foreign investment that is directed to sell products on the domestic market. The product must be either exported or sold to foreigners in China in sufficiently large amounts to provide the foreign exchange earnings to provide a return to foreign investment. A large share of potential foreign investors, who would invest only to reach the large Chinese domestic market, will be deterred from investing until such times as the yuan is made a freely convertible currency, allowing than to convert domestic market earnings to foreign exchange that can be repatrioted.

A second constraint is the high cost of operating in China. Not only rents and services artificially inflated in price by the Chinese government, labor costs are also substantially inflated by the demand that foreign firms pay several times more for labor than do domestic firms. The unskilled wage rate paid by Chinese firms is already held above a true market rate by state policies that effectively preclude rural residents from competing for entry level jobs in manufacturing. Foreign firms play a substantial further multiple over the already inflated domestic wage rate. Thus, a primary potential attraction for foreign investors in China, relatively low cost labor, is almost completely eroded. Foreign firms find other developing countries provide more attractive environments for manufacturing labor intensive products.

As a result foreign investment in China is effectively limited to projects that provide goods or services to foreigners or which aim to exploit China's natural resources. Thus the large concentration of investment in hotel and tourist services and the dependence of manufacturing ventures, such as the Jeep project, on selling their products in large part to other foreign firms operating in China. Manufacturing for foreigners is a very limited market and does not provide the basis for much growth of foreign investment.

Even investment to exploit natural resources will be limited. The failure of most multinational oil companies to find commercially exploitable petroleum reserves has already led to a reduced foreign presence and investment in offshore exploration. Even where known reserves exist--such as the Arco natural gas find South of Hainan Island or the large coal reserves of the Pingshuo Coal Mine in Shansi--the

Chinese have not yet proven sufficiently flexible to respond to changing world market conditions. Major obstacles have been encountered in arranging the international financing for both of these projects. The failures to move ahead with the joint venture in coal, signed in 1985 after more than five years of negotiation, would be a devastating blow to China's hopes for further joint venture capital. The project, which would create the world's largest open-pit coal mine, is the single largest joint venture in China.

Implications for trade with the United States

The analysis above suggests that we should expect China's economy and trade to grow more slowly in the years ahead and that the investment climate is substantially less conducive to large-scale direct private investment than was thought by many only a few years ago. Nonetheless China's economy, because of its high rate of investment will probably continue to grow at a rate quite respectable by developing country standards and to be accompanied by significant trade growth as well. Growth rates of four to five percent for national income and five to six percent for trade--both in real terms--seem well within the capacity of the economy. Even under this moderate growth scenario Chinese total trade turnover would rise by from forty-two to fifty-six billion dollars between 1986 and 1995.

How well is the United States positioned to benefit from trade with China in the context of this projection of China's own trade growth?

The central argument that I wish to present is that both Japan and the Soviet Union and the countries of Eastern Europe are likely to be major beneficiaries of an expanding trade relationship with China. This does not mean that Sino-United States trade will not expand. But an examination of events of the past decade suggests that Japan has gained an usually strong position in the China market and that despite lower Sino-Japanese trade in 1986 that Japan has laid the groundwork for an increasingly close trade relationship.

At the same time China's trade with the Soviet Union and the countries of East Europe is also growing rapidly, but for a different set of reasons. Those include an explicit Chinese decision in 1982 to adopt a more equidistant position between the two super powers, improving party to party relations with the Soviets and particularly the East European countries, and the apparent economic advantage of trade with other Socialist countries, which is essentially barter in nature and does not involve the difficulties of selling on the world market.

Japan has been China's largest single trading partner for two decades and the increasing importance and complexity of the bilateral economic relationship since China's adoption of the open door policy in the late 1970s is evident in several ways. Most significantly, the China market is of growing importance to Japanese firms, as reflected in China's rising rank among Japan's trading partners. Japan has long been China's top trading partner but China became one of Japan's most important trading partners only in recent years, rising to number two in 1985. This is a remarkable development since at the onset of the reform process China was only Japan's eighth largest trading partner.

Put alternatively it was once argued that as China's trade grew that Japan's dominant position in the China market would erode. But this has not happened. China's total trade has soared and, since Japan has retained its market share, the bilateral trade volume has become large in absolute terms and the gap between the volume of Sino-Japanese trade and trade between China and other partners has grown.

Second, Japan has become the largest national supplier of aid to China. Through its Overseas Economic Cooperation Fund (OECF) Japan in two development loan packages (1979 and 1984) committed more than three and a half billion U.S. dollars to aid various construction projects, projects that already have had and will continue to have a positive effect on the bilateral trade relationship. The most obvious examples are Japanese support for rail line and port improvements that will increase China's ability to export more coal and petroleum to Japan. In 1983, for example, a

7.6 billion yen loan was extended for the electrification of the Baoji (Shaansi) to Zhengzhou (Henan) rail line, substantially increasing the carrying capacity of the rail system leading out of Shaansi Province where almost half of China's coal is mined. The terms of the loan are extremely generous compared to normal commercial credit. The repayment period is 30 years with a ten year grace period, meaning the repayments will not begin until the mid-1990s, and the interest rate is only 3.25 percent per annum. In terms of their grant component these loans approach those made by the international development Association of the World Bank, generally considered the most favorable source of long-term economic development credits. Earlier OECF financial commitments were made for port development at Shijiusuo, improvements of the Yanzhou-Shijiusuo rail line, and the Beijing-Qinhuangdao rail line.

Japan's aid program contributes to increased bilateral trade for two reasons. First, although the loans are untied and thus in principle can be used by the Chinese to finance the procurement of project-related equipment, supplies, and consulting and engineering services from any country, the Chinese utilize about three-quarters of the funds to purchase equipment, facilities, and services from Japan. Second, the projects funded by OECF are all designed to facilitate the flow of Chinese exports to Japan. Almost half of Japan's imports from China consist of crude oil, petroleum products, and coal. The port and rail development projects supported by OECF loans will facilitate both the domestic transport of these commodities to major Chinese ports and the loading of the goods in the ports.

The third manifestation of the increasing complexity of the bilateral Sino-Japanese economic relation is in credit markets. Through several channels Japan has become the most important international financial market for China. Japanese Export-Import Bank credits of about two billion dollars were extended in 1979 to finance the development of energy resources. These loans were for fifteen years with an annual interest rate of 6.25 percent. The Chinese have also raised substantial funds in the Japanese bond market. From late 1981 through mid-1986 various Chinese borrowers floated eleven bond issues in the Japanese market. The issuers include the Bank of China, the China International Trust and Investment Company (CITIC), and two of the provincial branches of CITIC, the Fujian Investment and Enterprise Corporation (FIEC) and the Shanghai Investment and Trust Corporation (SITCO).

Cumulatively, by mid-1986, China had borrowed the equivalent of almost two billion U.S. dollars on international bond markets, the great majority in Japan. And, even though China made its first offering on the Eurodollar bond market in 1986, Japan is likely to remain a critical market for most Chinese issues of international bonds. Finally, Japanese banks have been major suppliers of commercial credit to China.

By contrast, the Sino-American economic relationship does not reflect the increasingly complexity evident in the Sino-Japanese case. Unlike Japan, which pursued a policy of unofficial trade relations prior to the normalization of relations in the early 1970s, the United States had no trade relationship with China until 1972. Following the initiation of official, direct Sino-American contacts in 1971-72, the institutional framework to facilitate trade developed rapidly. The United States lifted its embargo on commercial relations with China in mid-1971 and, after formal diplomatic relations were established in 1978, a bilateral trade agreement was signed in 1979. Shortly thereafter the United States granted China most-favored-nation (MFN) status, access to the export credit facilities of the United States Export-Import Bank (Eximbank), eligibility for technical assistance from United States government agencies such as the United States Army Corps of Engineers on a compensatory basis, and eligibility for the operations of the United States Overseas Private Investment Corporation (OPIC).

As the institutional framework was put in place trade volume grew rapidly. Total trade turnover reached 7.4 billion U.S. dollars in 1985, 3 times the level of 1979, the last year trade was conducted without the benefit of MFN status for China. Throughout this period the United States has remained China's third largest trading partner, after Japan and Hong Kong.

Despite this growth, the bilateral economic relationship with China is far less important to the United States than to Japan. Whereas China is Japan's second largest trading partner, United States trade with China is still miniscule relative to total United States trade. Even in 1985, when bilateral trade reached an all time high, China was only 16th among United States trading partners, ranking behind Canada, Japan, Mexico, all of our major trade partners in Western Europe, as well as Taiwan, Singapore, Hong Kong, Brazil, and Venezuela.

The reasons for this lag in the bilateral trade volume are poorly understood but clearly include United States controls on exports of high technology products to China; United States import restrictions on Chinese goods; and the failure of the United States to extend the benefits of the generalized system of preferences to Chinese sales in the American market.

Partly as a result of these frictions in the bilateral trade relationship China's trade with the countries of the Europe Economic Community in recent years has been growing more rapidly than trade with the United States. As a result of this trend in 1985 bilateral EEC-China trade surpassed that of U.S.-China trade for the first time.

Not only have United States export controls, import restrictions, and tariff policies inhibited the growth of the bilateral U.S.-China trade relations, the United States economic relationship with China does not reflect the growing complexity evident in the case of Japan. The United States has not become a significant supplier of aid to the Chinese. Technical assistance can be provided by U.S. government agencies but only on a fee-for-service basis that in principle covers the costs incurred by the United States. Most of the official prohibitions on U.S. government credits to China were lifted, either when MFN status was granted or through subsequent legislative action. However, there is no official bilateral aid program for China administered by the United States Agency for International Development and China to date has not utilized what modest credits are available through other channels. United States Eximbank credits of $125.5 million were authorized in 1981 but no new credits were extended in the following five years. In mid-1986 new credits of $65.4 million were extended to the Bank of China to finance the purchase of turbine generators, boilers, and other equipment for four coal-fired electric power plants but the magnitutde of the U.S. Eximbank loans continues to pale compared with those offered by the Japanese Export Import Bank. Moreover, this situation is unlikely to change until the U.S. Export-Import Bank offers interest rates and commitment fees that are competitive with the Japanese and other countries.

Second, possible legal challenges have kept the Chinese out of the U.S. financial markets. U.S. courts have ruled that the Chinese government is in default on some pre-1949 bonds which were issued in the United States. The Communist government has refused to make payments on those bonds and argued in legal appeal they are not responsible for the debt obligations issued by the Qing dynasty government. Although China won on appeal the possibility of further legal claims may continue to keep the Chinese out of the American bond market. Finally, there have been only extremely modest commercial credits extended by United States Banks.

The absence of a United States aid program for China may be particularly troubling in the bilateral economic relationship because it is not consistent with the often repeated statement of high ranking United States officials that China's economic modernization and integration into the world economy is in the long-run U.S.-interest. In short, there has been a disparity between our articulated policy goals and the means used to achieve them.

Similar tensions have been due to our export controls and import barriers. From the Chinese perspective there is inconsistency between President Reagan's announcement in May of 1983 that China is a "friendly non-allied country" and the continued need for U.S. firms to obtain export licenses for a broad range of products. These procedures at best are frequently a burden to U.S. firms, adding substantially to their costs and reducing their profits. At worst, when licenses are not approved they sometimes provide virtually a guaranteed market to Western European and Japanese firms who do not find their export capacity similarly curtailed by their governments.

Similarly, the Chinese ask how the United States can expect China to become part of the international trading system when we erect increasingly stringent controls on United States imports of China's labor intensive products.

In part because of the difficulties encountered in attempting to reform their own trade sector to provide greater incentives for exports and the frustration with increased protectionism in the United States and Europe, China is in the process of accelerating its trade with both the Soviet Union and Eastern Europe. Although that trade expansion has not been widely noticed, if present trends continue Sino-Soviet trade will surpass Sino-American trade by 1988 or 1989. This is hardly consistent with the image that the Chinese have sought to project of an opening to the west but it is consistent with the revolution in Sino-Soviet economic relations of the past five years.

The turning point came in the fall of 1982, when after a several year pause, the Chinese and the Soviets resumed their long-stalled deputy ministerial level talks between Leonid Ilyichev and Qian Qichen. The first round of discussions established the principle of biannual talks with one round of discussions in each capital.

Shortly after the second round of talks in the spring of 1983 both sides announced that border trade, which had been suspended since 1962, would resume. In 1984 the Chinese announced the expansion of rail loading facilities in Heilongjiang Province and the Inner Mongolian Autonomous Region to facilitate the expanded flow of goods between China and the Soviet Union and at the end of the year, at the conclusion of talks between Ivan V. Arkhipov, Soviet First Deputy Prime Minister, and Yao Yilin, a Chinese Deputy Prime Minister, the two countries signed agreements covering economic and scientific and technical cooperation.

The most important feature of the agreements was the Soviet commitment to provide extensive technical and other assistance to upgrade seventeen major Chinese industrial plants, which were among the much larger number of projects that were built with Soviet assistance in the 1950s, as well as to assist in building seven new plants. The talks with First Deputy Prime Minister Arkhipov, who is an alternate member of the Soviet Politburo and the highest ranking Soviet visitor to China since 1969, were said to be particularly warm. He was personally greeted by senior Chinese Politburo members who worked with him in the 1950s when he was the chief of the Soviet technical assistance program for China. Within months of the Arkhipov - Yao Yilin talks in Beijing, Yao Yilin flew to Moscow to sign a five-year trade and economic agreement that called for a doubling of bilateral trade during the period 1986-1990. The two socialist states have also agreed to hold trade exhibitions in each other's capitals. The first Chinese trade exhibit since 1953 was held in Moscow in July and August 1986 and the Soviets were to open an industrial and trade exhibit in Peking in late 1986. Both sides have agreed to annual fairs through 1990.

In addition to the five-year trade agreement and reciprocal trade fairs, other indications suggest that economic relations will continue to improve and bilateral trade continue to expand. Under the policies of decentralization in which trade authority in China has devolved to provincial and lower levels of government administration, provincial and regional officials in both Northeast and Northwest China have rapidly promoted trade with the Soviet Union. Most notable is the reopening of border trade, locally approved trade that takes place outside the formal bilateral state-to-state trade agreements. The volume of such trade has grown rapidly, more than quadrupling in 1984 to reach well over one hundred million U.S. dollars.

Second, Chinese national policy presently encourages the western economic orientation of provinces in the Northwest, such as Xinjiang. Hu Yaobang, the Chinese Communist Party General Secretary, for example, in recent years has twice visited Xinjiang and encouraged the region to develop trade ties with Western Asia including Pakistan and Middle Eastern countries, as well as the Soviet Union. Major new investments in transport infrastructure have been and are being made to facilitate the trade flows with these regions. The southern extension of the Lanchou-Urumchi rail line, running from Turfan to Korla has recently been extended over one thousand kilometers to Kashgar in southern Xinjiang. From there a new road has been constructed and opened to the Pakistani border.

The Chinese also decided in recent years to extend the Lanchou-Urumchi rail line west to the Soviet Union to join a main Soviet east-west line at Alma Alta. When completed the line will be the first international rail link in China's far Northwest. The work on the first 240 kilometers, from Urumchi to Wusu, began in May 1985. The priority assigned to the completion of the project is suggested by Chinese claims that the speed of construction in the first five months surpassed that of all rail lines constructed in China since 1949. Completion of the first segment will be in late 1987 or early 1988 and will be followed by the second phase which will extend the line to the Soviet border.

International air service from the Northwest is also being established. In 1986, the Chinese Civil Aviation Administration announced the opening of service from Urumchi, the capital of Xinjiang, to Addis Ababa, the capital of Ethiopia. A new Xinjiang regional aviation company has been established and four regional airports, including one at Hotan, have been expanded and upgraded to open local air service to Pakistan and the Soviet Union, using TU-154 medium-range jet aircraft purchased from the Soviet Union.

The Chinese are also pursuing closer ties with the countries of Eastern Europe. In 1985 China signed, for the first time, five-year trade agreements with East Germany, Poland, Hungary, Czechoslovakia, and Bulgaria and scheduled major trade exhibits in East Germany and Hungary. Trade ties with Rumania and Yugoslavia, which have traditionally benefited from China's closer political ties with those nations, have also been strengthened.

There is an underlying economic rationale to China's improved economic relations with the Soviet Union and Eastern Europe. Trade among socialist countries is conducted on a barter basis obviating the need to utilize scarce foreign exchange. As all of these countries have experienced some difficulty in expanding their exports to market economies in recent years, the barter feature of the trade is perceived by both sides as offering some advantage.

It is sometimes argued that the trade patterns of China and the Soviet Union are more competitive than complementary and do not form the basis of a substantial bilateral trade relationship. In this view, since there is a certain similarity in the import and export commodities of each country, trade will be limited. They both, for example, have exported petroleum and petroleum products and imported foodgrains. Moreover, the Soviet Union will not be to supply China with the high technology goods essential to China's ambitious modernization program and there is a paucity of important Chinese exports that would find a market in the Soviet Union.

But this argument about lack of complimentarity overlooks the fact that China imports large quantities of raw materials, standard industrial products such as steel and many manufactured goods, such as electric power generating equipment, that are characterized by a relatively low level of technological sophistication. Thus the Soviet Union and Eastern European countries supply growing volumes of critical commodities to China, notably timber, rolled steel, and electrical equipment. Moreover, the Chinese purchase other more sophisticated equipment and machinery such as diesel locomotives and jet aircraft because of the presumed price advantage.

Finally, to upgrade its plants from the 1950s the Chinese need machinery and parts that simply are not available from other sources of supply.

On the other side of the trade equation the Soviet Union and Eastern Europe can serve as an important market for Chinese goods, some of which face increased barriers in western markets. For example, the Soviet Union is an increasingly important market for Chinese textile products. In 1985 the Chinese exported about six hundred million U.S. dollars worth of cotton cloth, garments, and cotton to the Soviet Union and Eastern European countries, a sixty percent increase over 1984. Indeed as rising protectionism in textiles has curtailed the growth of Chinese exports to market economies, the development of the Eastern European and Soviet markets has been increasingly important. The expansion of the market for textiles in the socialist countries in 1985 largely compensated for the fall in sales to market economies, allowing China's total textile export volume to remain constant.

Similarly the Soviet Union is a growing market for Chinese agricultural exports, including processed foods, foodgrains and soybeans, and of light industrial goods, primarily consumer goods such as handicrafts, thermos flasks, flashlights, and other household articles. There is no reason to presume that this mutually profitable bilateral trade flow will not continue to grow in the future.

Beyond the increased flow of goods and of technical assistance, the Sino-Soviet economic relationship may expand to include a Chinese role in developing the vast mineral and forest resources of Siberia. A large share of the natural resources, particularly the energy, that is needed for future Soviet growth lies to the east of the European industrialized Russian heartland. Gorbachev's recent call for accelerated development of the Soviet Far East is only the most recent acknowledgement of the vast long-term potential contribution of Siberian resources to Soviet economic growth.

But the Soviets have been notoriously unsuccessful in encouraging migration to these regions, and as long ago as the 1950s expressed an interest in utilizing Chinese labor to exploit Siberian resources. While the prospective cooperation in the Khrushchev era was aborted by the Soviet withdrawal of technical assistance from China in mid-1960, according to some reports Khrushchev's successors have revived the discussion by requesting that the Chinese supply labor to assist in Siberian development. And some Chinese officials seem ready to pursue this option as a means of paying for increased imports of Soviet raw materials, notably timber. This would put China in a position similar to the North Korean government which also supplies labor for Siberian projects in exchange for raw materials such as timber.

In Peking officials who are not committed to the primacy of the Chinese relationship with the United States even speak of a possible trilateral form of cooperation in Siberia involving Soviet resources, Japanese capital, and Chinese labor. This is a rather remarkable development considering that the Chinese in the mid-1970's brought pressure to bear against the Japanese when they were considering Moscow's invitation to participate in several Siberian development projects, notably a combined pipeline-railroad to ship West Siberian petroleum to Soviet Pacific ports.

Implications for United States Policy

China's emergence as a major economic power has important implications for the United States because of the expanding bilateral economic relationship, increasing Sino-

United States competition in third country markets, and its broader effects on the world economy. Despite these multiple sources of importance of China's modernization the United States has not developed a consistent strategy to deal with rise of the Peoples' Republic of China as a major economic power.

Over time policy formulation has vacillated. China has been thought of variously as a potential counterweight to Soviet power in East Asia; a huge untapped market for U.S. goods and investment; a potential claimant on finite world resources; a socialist country that we might induce to enter the capitalist world; and, more recently as a non-market economy with substantial nontariff barriers to trade. Each of these perspectives suggests a different mix of policy in the economic sphere.

The articulated premise of our policy toward China beginning in the Carter administration was that a strong, secure, and modernizing China is in our long-run interest. The United States would prefer a China that is politically stable, capable at a minimum of feeding its huge and growing population without placing extraordinary demands on world markets, and which is drawn into world product and capital markets rather than remaining inward looking. That formulation was expressed most explicitly by Vice-President Walter Mondale in a major address in Peking in 1979.

Yet there was a gulf between this broad vision of and support in principle for a moderning China, on the one hand,

and specific United States policies, on the other. As discussed above, these policies restrict Chinese access to the United States market, deny GSP status for Chinese goods, and deny bilateral economic aid for China.

In part, these inconsistencies stem from a preoccupation with the potential security dimension of the bilateral relationship. In short there has been a tendency to define China's strength primarily in military rather than economic terms. This was implicit in the initial opening of the Nixon administration to China in 1971-72, became explicit during the Carter administration when the United States Secretary of Defense Harold Brown visited China, and continues under the Reagan administration. During the Brown visit the United States announced its willingness to sell radar, transport aircraft, communications equipment and other nonlethal military equipment. Despite the lack of any military sales, under the Reagan administration the policy was expanded to include a willingness to sell arms to China.

This continuing attempt to develop a strategic relationship, reflected in repeated visits to China by successive U.S. Defense Secretaries and high ranking U.S. military leaders may be ill-advised. Most important, a strategic relationship does not provide the most sound basis for a sustainable bilateral relationship between China and the United States. It has been clear from the outset of China's renewed modernization and reform drive in the late 1970s that military modernization is the lowest priority for the Chinese, following the modernization of agriculture, industry, and science and technology. China's own defense spending has been falling in not only as a share of total government spending but even in absolute terms in recent years.

Equally important our preoccupation with developing a security relationship with China may have contributed to our inability to formulate a consistent, sustainable economic relationship. We have been caught off-guard, for example, by increased Sino-United States competition in third country markets, notably for agricultural goods.

Competition between the United States and China in third country markets was once thought to be an unlikely possibility given the huge disparities in the level of economic development and technological sophistication of the two countries. But the success of China's agricultural reforms and the resulting changes in its trade patterns in agricultural products have had major implications for the United States. Not only has the United States lost a market in China for several million tons of wheat annually, it has also lost large grain sales to Japan, South Korea, and perhaps even to the Soviet Union because Chinese products have replaced those previously purchased from the United States. Similarly the United States has lost substantial sales of cotton to Japan and the Soviet Union because of tripling of Chinese cotton output between 1978 and 1985 and the increasingly close trade ties between China and other countries in East Asia, including the Soviet Union. In short, like Japan in the 1920s China is now becoming a significant factor in world markets for some important traded commodities. This will lead to friction in the bilateral relationship or to competition in third country markets for a growing number of commodities.

Japan, not the United States, has reaped a major share of the benefits of China's growing international trade. The Japanese have taken a long run strategic view of the China market and committed commensurate resources to its development. For example, they began consumer oriented advertising in China almost a decade ago when most other Western countries thought that China would never be in the market for consumer durable goods. The Japanese, through a variety of institutions have developed significantly greater research capability than the United States on China's trade and its domestic economy. That has resulted in Japanese firms probably being the best informed in the world about developments in the China market. The Japanese External Trade Organization, under the Ministry of International Trade and Industry, maintains a large research staff in its China section office in Tokyo, a liaison office in Peking and a second China office in Shanghai. The quasi-private Japan-China Association on Economy and Trade also maintains offices in China and a research program in Tokyo. Finally, longer term research on China's economy undertaken by organizations such as the Institute of Developing Economies is supported by the Japanese government. During the period when the Japanese have done more to support economic data gathering and research on China, including the purchase of large scale economic data sets from the Chinese that are not available in United States, the United States government eliminated the only organization with the capacity for sustained, in depth research on the Chinese economy--the China Branch of the Office of Economic Research of the Central Intelligence Agency. Budgetary constraints have prevented publication by other United States government agencies of important research on China's economy and important protocols between China and American agencies have not been funded on the United States side, depriving the United States of important sources of information on developments in the Chinese economy.

Similarly, Japanese firms have taken a longer term view of the China market as compared to their United States counterparts. Japanese firms, for example, maintain five times more resident representative offices in China than do American firms. And whereas United States firm offices are largely in Peking the Japanese firms are widely distributed geographically. They have as many representatives in Shanghai as do United States firms in all of China but they also maintain offices in Qingdao, Nanjing, Fuzhou and even in distant Sinjiang.

Mr. ROMBERG. Thank you, very much. Allen Whiting, please proceed.

STATEMENT OF ALLEN S. WHITING, PROFESSOR OF POLITICAL SCIENCE, AND DIRECTOR, CENTER FOR EAST ASIAN STUDIES, UNIVERSITY OF ARIZONA

Mr. WHITING. I would like to thank Chairman Obey and the Joint Economic Committee for inviting me here as a political scientist in a den of economists. I admire and respect my economic colleagues and their projections, but I do think at one point we have to add a caution; that is, economic decisions in China, as elsewhere, are subject to political influences. It is what the economists might call the nonrational element. I won't use the term irrational. I do think that from an economic standpoint nonrational is a valid way of describing it.

Let me remind you that had we been holding these hearings in 1956 or even 1959 and we were talking about China's foreign trade, its orientation, its future projections no one—political or economic—would have forecast in 1959 that Sino-Soviet trade and Sino-East European trade, Sino-Soviet aid relationships, would be completely ruptured within a year or two. And it was not only Khrushchev's decision to end that aid and to cut that trade; it was really Mao Tsetung's political provocations in challenging Khrushchev's leadership of the international Communist movement which prompted Khrushchev to react in that manner.

In fact, as early as 1958, Mao told a very selected group of his colleagues that from now on we're going to put self-reliance first and aid second.

Now, admittedly, Mao Tsetung was an exceptionally powerful individual in the decisionmaking processes in China, and he was notorious for putting politics ahead of economics, but I would say that if we look at the post-Mao political record in China, the willingness to depend on the foreigner for economic development goes against the grain of Chinese concern about societal development—what might be called the Chinese way of life. And this has triggered repeated challenges to Deng Xiaoping's open door policy since Mao's death.

These challenges have not just come from ideologues at high party levels. They have come from university students. They've come from various sectors within the public as well as the governmental society.

So in addition to a historic tension that goes back to the 19th century between those who advocate Westernization and those who defend Sino-centrism, there is a natural tendency to blame the foreigner when things go wrong. If a product doesn't work or the factory fails, it is easier and safer to fix the cause on foreign equipment or foreign advice that to admit Chinese culpability.

It is within this general context that I would like to examine the dominant role of Japan in China's foreign trades and, to a lesser extent, in foreign investment, and place that role in political perspective.

I will reinforce Nick Lardy's admonitions concerning what can and should be done if American business is going to compete with

Japan in China's economic modernization, but I will approach it from a different angle.

This summer I spent 2 months in nine Chinese cities, from the northeast to the south, interviewing specialists in research institutes, scholars in universities, editors, writers, and managers of Sino-Japanese joint ventures. I also spent 3 weeks in Japan interviewing the same spread of specialists involved in the Sino-Japanese relationship.

I came away from these conversations struck both by the advantages and the disadvantages that the Japanese face as they seek to control and expand their share of the China market.

Now the advantages they face have been already alluded to not only by Nick and Chairman Obey but by many others. Our popular press informs you about Japan being No. 1.

But if you go through nine cities living in Chinese hotels, coping with the lack of power, the lack of air conditioning, the quality of service, you have to admire their grit and personal determination to persist.

The reason the Americans hole up in Peking and don't go out to the boonies is in part a reluctance to face the facts of what life in a Third World country is like. We should not forget, as the Chinese themselves say, this is a Third World developing nation.

The bureaucratic obstacles and delays, the changes in trade and exchange policy, the short-term losses in startup, in training—all of the complaints that foreign businessmen have articulated in the last several years are felt much more keenly because the Japanese are staying there year after year.

Their persistence, of course, is facilitated by their proximity to home base. In 5 or 6 hours they can get back to headquarters. They can get back to family without a jet lag. This is further facilitated by a cultural compatibility, although it tends to be exaggerated in the Western world. At least you feel at home if you're a Japanese looking at Chinese signs and dealing with Chinese food, even if the life styles in Tokyo and Peking are markedly different. Their familiarity with the turf in China has already been alluded to by Professor Lardy and the research staffs in Japan are among the best I have encountered anywhere in the world.

But what are the disadvantages? The first and foremost one that I encountered at all levels of conversation and all ages of interviewee is a deep resentment and mistrust of Japan for economic development. It is impossible to exaggerate the depth of bitterness about the war, the Nanjing massacre being the foremost symbol of this bitterness. From the Chinese perspective the Japanese have not apologized, they do not dwell on that past in a historically accurate way, and they do not own up to the guilt that they must bear. This prompts many Chinese to compare them unfavorably with West Germany.

At the official level, of course, protests have come through the foreign minister over the revision of Japanese textbooks concerning World War II at the high school level, over visits to the Yosukuni Shrine in Tokyo which is seen by Chinese, Koreans, and many Asians as glorifying Japanese militarism, and over incidental private practices such as the celebration of Chiang Kaishek's 100th birthday. These protests express at the official level what is amplified at the unofficial level. These protests being, of course, publicized in the press, activate and stimulate a feeling that Japan is the last country Chinese would like to have to deal with or rely upon for economic modernization.

In September 1985, thousands of university students protested as much in private as in public against what was called the "Japanese economic invasion." Of course, many of the student protesters had a longer agenda: local conditions within the universities, conditions in society, problems of the reform, corruption, and the special privileges that Chinese officials and their offspring in the universities tended to enjoy. But there is no getting away from the core of that anti-Japanese feeling among a generation that has no first-hand experience of suffering under the Japanese invasion.

A second aspect of Chinese feelings about this dependence is the lack of trust in Japanese businessmen and their practices. One expects to hear antiforeign sentiments in any Third World country. It is not a comfortable position, being in the student role and having someone else tell you what to do. But the degree to which the rumor level about the Japanese business practices spreads across that country is I think a politically relevant fact.

Japanese are accused of bidding low and once getting the contract overcharging for spare parts and maintenance and service. They are believed to hold back key parts, to deny the technological know-how if not the technological parts themselves in order to keep China back. They are accused of only wanting quick profits, not helping China with long-term investments. They are believed to sell their best quality goods to the United States and Western Europe and palm off the second-rate stuff to China.

Now I'm reporting beliefs and rumors. I am not asking what are the facts. I am in no position to ascertain them and there are notable contradictions in Chinese behavior as opposed to Chinese rumor. Few Chinese will buy a Chinese television set at a cheaper price if a Japanese one is available because of the greater confidence in the quality of that particular set.

But in the aggregate, the lack of confidence that the relationship with Japan is a healthy one economically is found in many of the cities and in many of the areas that I visited.

Of course, as in all international trade, quality and delivery time do not always match up with contract and expectations. In 1985 the most notable case publicized in China concerned some 7,000 Mitsubishi trucks that were so defective they had to be recalled.

From the Japanese side, there is a recognition that massive purchases on the China front without supporting distribution and service facilities can lead to misuse on the local level and to a lack of information and feedback in terms of product performance. But objective explanations don't always affect subjective perceptions and the perception in China in most cases is that the Japanese are not to be trusted as businessmen.

The advantages for both China and Japan of having a high trade relationship outweigh the disadvantages. There is no denying that Japan is No. 1 in the Chinese trade picture and, I would agree with Nick, is likely to remain No. 1. But do these disadvantages offer any lessons and opportunities to American business and American

Government policy with respect to the China market? I think they do.

First of all, we are, perhaps temporarily, in a uniquely advantageous foreign exchange position. The skyrocketing of the yen and the fall of the dollar has given the U.S. competition a singular advantage in the past year and the Chinese are quite sensitive to this.

Second, we do have a potential pool of Americans who are willing to put up with the nitty-gritty of sweating out weeks, months, perhaps years developing a China market. That potential is the numbers of American graduate students trained in Chinese language and Chinese culture. They are eager for a Chinese experience, having invested years in that program. I find it ironic in the extreme at a time when China is opening up and American business needs this reservoir of human power, the funding for National Education Fellowships in Washington is threatened with being cut.

You cannot expect people to put 4 years of training into preparation for a China business career on their own resources. It simply is too expensive. It is too arduous. And American business has not made it a promising venture.

The U.S. personal style, the American way of dealing with other people, particularly Chinese, is another advantage I think we ought to recognize very frankly. We do have our images of the "ugly American." There are people who are back-slappers, who are excessive in their profusion of personal physical friendship. These do not go well in China or in many cultures. But basically, the informal, easy, relaxed American operates much more easily in that environment than the more formal, reserved, and totally withdrawn Japanese.

Personal style is something that we have which, if properly used, gives us an edge in that market.

Japanese are aware of their own deficiencies. They are very self-critical about their business practices. One of the most thoughtful Japanese specialists I spoke to said, "We have always been the student. The Chinese have been the teacher. It's not easy for them to be the student and we are not very good teachers."

As much as I would caution against expecting 1 billion Chinese to be consumers of any particular American product, I do think there are opportunities in China. Chinese needs and American gains can be realized with much more thoughtful, much more informed, and a much more determined investment of time, money, and energy. Thank you.

[The complete statement of Mr. Whiting follows:]

CHINESE FOREIGN TRADE IN POLITICAL PERSPECTIVE

by
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Statement prepared for the Joint Economic Committee symposium on U.S.-Pacific Rim Relations, December 11-12, 1986.

CHINESE FOREIGN TRADE IN POLITICAL PERSPECTIVE

by

Allen S. Whiting

Introduction

Any attempt to analyze recent foreign trade of the People's Republic of China (PRC) so as to project its course over the next ten to fifteen years confronts a minefield of uncertainties approached from different perspectives. These hazards deserve attention in advance to guard against the fallacious assumption that "the figures speak for themselves." Only after limning the analytic problems can even the most tentative projections be offered with due recognition of their fragility.

One hazard, common to all such forecasts, is the problematic nature of the international economy when projecting developments to the year 2000. This is the time when, according to Deng Xiaoping, the PRC will have quadrupled its productivity and per capita income will reach $1,000. The recent past serves to caution against the long-run future being predictable. Thus in 1978-79, foreign and Chinese analysts alike counted on a bonanza in export earnings from presumed off-shore oil reserves. Few foresaw a global energy glut in the 1980s that would force oil prices sharply downward with no clear prospect of their recovery to previous peak levels. The chimera of a vast off-shore oil potential continues to elude foreign prospectors. Should it become reality, the domestic

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demand for oil will challenge its potential role in foreign exchange earnings. Infrastructure requirements for the transport of onshore oil to foreign as well as domestic markets further complicates projecting its availability for export.

In addition to capability, the durability of economic policy comes into question when viewed against recent history. The suddenness with which the first post-Mao plans enunciated in 1978 by Premier Hua Guofeng were scrapped within two years in favor of retrenchment shocked Japanese firms that had contracted for the Baoshan steel complex and lesser projects.[1] Two years later reforms followed that virtually revolutionized economic policy.

Then in 1984-85 Beijing decentralized control over foreign exchange and foreign trade in order to encourage the importation of consumer goods to absorb the excess currency paid through increased wages and also the importation of foreign technology. The result was an alarming fall in foreign exchange reserves, from approximately $16 to $11 billion in less than a year. Beijing reacted by recentralizing control and forcing the wholesale suspension or cancellation of import orders of consumer goods. At the same time fourteen cities which had been designated as privileged foreign trade and investment centers were suddenly left in limbo as their new privileges were indefinitely postponed. These successive shifts not only caution against straight line projections of present policy but they also impede extrapolating from past performance.

The cumulative impact of reform on output, wages, prices, and consumption can only be conjectured at this point. Failures in policy implementation are inevitable, whether from inexperience or deliberate resistance, in a society of one billion people, largely without secondary education, spread over much of a continent, with behavior patterns rooted in several millennia of continuous society. Only the passage of time, perhaps a decade or more, will reveal the full consequences of Deng's dismantling of Mao's economic system and replacing it with his own.

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[1] Chae-jin Lee, China and Japan, New Diplomacy (Stanford: Hoover Institution Press, 1984), details the Baoshan story through authoritative interviews in China and Japan. The first phase began production in September 1985 with a 3 million ton capacity.

Even the more mundane question of PRC trade statistics plagues the simple calculation based on yearly figures. Sino-Japanese trade, for instance, offers at least five different data sets, none of which agree on either the total amount or the breakdown into exports and imports. The Ministry of Foreign Trade (MOFERT) issues its data first, followed in several weeks with differing data from the State Statistical Bureau (SSB). Understandably the initial information receives the wider circulation abroad by foreign media. However the SSB compilation is more frequently utilized by Chinese analysts, particularly because it is included in annual statistical handbooks. Still another set of figures emanates from China's trading partners with differing bases of calculation, including in the American case identification of goods transshipped through hong Kong as from China while Beijing simply lists them under "Hong Kong/Macao."[2] Because our interest is in the domestic political perceptions of and reactions to foreign trade we will utilize SSB data unless otherwise indicated.

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[2] MOFERT figures on Sino-Japanese trade for 1985-86 may be found in Beijing Review, No. 30, July 28, 1986. SSB differing figures are in Xinhua, English, August 13, 1986 in Foreign Broadcast Information Service, China (hereafter FBIS), August 15, 1986, pp. K 11-12. Japan's Ministry of Finance customs-clearance trade statistics are in Joji Ishida, "Japan-China Trade in 1985," China Newsletter, No. 61, March-April 1986. Earlier figures reconstructed from "China, International Trade," issued by the Central Intelligence Agency, are in John L. David, "China's International Trade and Finance," in China's Economy Looks Toward the Year 2000, Vol. 2. Economic Openness in Modernizing China, Selected Papers submitted to the Joint Economic Committee, Congress of the United States, May 21, 1986. Another American set is offered in China Business

This raises the problem of multiple perspectives, beyond the one cited in this essay's title. One might be called the objective or mathematical approach. Econometricians construct sophisticated models with alternative projections based on different assumptions and parameters that graphically portray various probability estimates, depending on specific scenarios.[3] These exercises in disciplined imagination are valuable heuristically but, given the aforementioned uncertainties, may accomplish little in forecasting reality.

Another set of perspectives is held by those directly involved in China's economic modernization as traders, investors, lenders, and advisors. A third locus of view lies with China's competitors in the world marketplace. These two groups entertain different hopes and fears as they peer into the future. The former will focus on the PRC ability to absorb technology that provides the seller access to this vast domestic market, while the latter group will worry about the impact such technology may have on PRC export capabilities. Conversely the investor or lender is concerned with the maintenance of quality controls necessary to assure repayment through expanding exports whereas the competitor may hope that the sheer scale of managing this huge enterprise precludes success in this regard.

Review periodically. A detailed explanation of the different bases for MOFERT and SSB calculations may be found in Masaharu Hishida, "China's Customs Clearance Statistics and General Administration of Customs," China Newsletter, No. 48, January-February 1984. SSB data can also be found in the annual Almanac of China's Foreign Economic Relations and Trade, published in Beijing and the annual Statistical Yearbook of China, published in Hong Kong.

[3] Christopher Findlay, Prue Phillips, and Rodney Tyers, China's Merchandise Trade: Composition and Export Growth in the 1980s. (Kuala Lumpur and Canberra, ASEAN-Australia Joint Research Project, 1985), ASEAN-Australia Economic Papers No. 19, is an excellent example.

Although these are important points of view to which we will accord some attention, it is a fourth perspective -- the Chinese -- which is central to our analysis. This choice derives from the degree to which domestic politics have heretofore affected PRC behavior and involvement in the international economic system. Historically the tension between inward and outward oriented approaches to modernization dates back more than a century as a subject of fierce debate and factional politics. Even Mao Zedong vacillated between the two orientations. Having declared a "lean to one side" policy in 1949, he nonetheless in 1958 "decided to make self-reliance our major policy and striving for foreign aid a secondary aim."[4] He thereupon provoked Khrushchev to the point of withdrawing all Soviet aid in 1960. Sino-Soviet trade plummeted from nearly half the PRC total in 1959 to 10.5% within five years.[5]

Whereas the objective economist, the hopeful trader or investor, and the fearful competitor all seek a factual and rational basis of forecasting China's economic development and foreign trade, the political analyst is compelled to add the subjective and possibly non-rational calculus that makes the issue of dependence versus independence a major variable. As recently as 1974-75, the so-called "Gang of Four" mounted a concerted attack against the importation of whole plants and equipment, largely from Japan, in exchange for raw materials, including oil, to arouse nativist sensitivities against a dying Zhou Enlai and his potential successor, Deng Xiaoping.[6]

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[4] Mao made this statement retrospectively in 1962, see "Talk At An Enlarged Central Work Conference," January 30, 1962, in Stuart Schram, ed., Mao Tse-tung Unrehearsed, Talks and Letters, 1956-71 (England: Penguin Books, 1974), p. 178.

[5] 1984 Almanac, op.cit.

[6] Allen S. Whiting, Chinese Domestic Politics and Foreign Policy in the 1970s (Ann Arbor: Michigan Papers on Chinese Studies, 1979), recounts the attack mounted mainly through allegorical articles, ostensibly of only histori-

To be sure, Mao's heritage has suffered badly in the wholesale rejection of the Cultural Revolution as "ten years of disaster." Deng's insistence that the new "open door" policy will last for at least fifty years or more is reiterated by his two proteges, Hu Yaobang as General Secretary of the Chinese Communist Party (CCP) and Zhao Ziyang as PRC Premier. This line is dutifully echoed in articles and editorials throughout the media aimed at domestic as well as foreign audiences. Yet the very insistence that the line will not change suggests internal skepticism if not actual opposition.

The linkage between foreign trade and dependency may strike an outside observer as slim at best, given the gross disparity between China's huge internal market and its relatively small external exchange. However the argument is not wholly a specious one. The goal of modernization encounters an immediate obstacle insofar as it must depend on the large-scale importation of technology and equipment that cannot be covered by matching exports of goods for which there is a limited demand abroad. The low level of economic development nonetheless places an inexorable demand for modernization if living standards are to be raised and adequate self-defense to be assured. This means that foreign loans and credits must mortgage future exports to pay for present imports. It also means that a crash program in technology transfer places a premium on foreign cooperation and advice both in its acquisition and in learning how to manufacture as well as use it.

These aspects of foreign trade, in turn, can arouse nativist elements whose fear of and hostility to foreign involvement in China's development draw on "a century of shame and humiliation" from the Opium War of 1839-41 to the end of World War II when spheres of influence and exploitation, real and perceived,

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cal relevance.

characterized the intrusion of foreign imperialism and capitalism.[7] Chinese scholars debated whether this intrusion caused or only coincided with the decline of the Qing dynasty and the political system which had prevailed for over two thousand years. But for most politicians, including Sun Yat-sen and Chiang Kai-shek as well as Mao, the main blame for China's ills rested on the foreigner.

Thus while in theory foreign trade can be separated from other forms of economic interaction, in practice, the linkage can be argued under certain circumstances. This linkage gains special political significance when a past opponent such as Japan or the United States is involved. It invites exploitation of a nationalistic issue by those who would challenge the relationship for genuine or opportunistic reasons. In September 1985 university students held anti-Japanese demonstrations in Beijing, Xian, Chengdu, and elsewhere protesting Tokyo's alleged "economic invasion" in the context of commemorating the 1931 seizure of Manchuria. Ostensibly student criticism was triggered by Prime Minister Nakasone's visit to the Yasakuni Shrine on August 15, the fortieth anniversary of Japan's surrender in World War II. The shrine contained the ashes of thirteen officials sentenced as war criminals by an international military tribunal. Actually however the students chose a safe nationalistic target, Japan, to camouflage in public their private opposition to various aspects of domestic policy associated with Deng's reforms, such as corruption, bureaucratic privilege, and inflation.[8] What might appear as a simple, rational cost-benefit calculation from an outside perspective can become a more complex and contentious relationship when viewed from within the Chinese political system. It is for this reason that we will eschew a conventional economic framework in favor of an approach which emphasizes the political problems and prospects, focusing on the comparative advantage of Japan versus the United States in Chinese foreign trade.

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[7] Kuang-sheng Liao, Anti-Foreignism and Modernization in China, 1860-1980 (Hong Kong: Chinese University Press, 1984) provides an historical overview with empirical research for the more recent period.

[8] Information gained through interviews in nine Chinese cities, June-August 1986.

Japanese Strengths

One advantage Japanese have in competing with Americans for China's trade is their determination to persist, regardless of problems that tend to discourage other entrepreneurs. Bureaucratic obstacles and delays continue to impede negotiation and communication. Policy changes in foreign trade and foreign exchange availability complicate planning production and managing inventory. Inordinate requirements for clearing imports of foreign items necessary to production hamper marketing schedules. Physical discomforts abound with uncertain power availability causing disruption in air conditioning and heating, together with poor service and food in many hotels.

Yet despite these and other problems, hundreds of Japanese businessmen and engineers stick it out under circumstances which Americans seem reluctant to fight. To be sure, the Japanese are uniquely favored in several ways. First, their proximity to headquarters and home permits them to return there in only four to five hours of flight with no jet lag and little expense. During what may be years of study and negotiation before signing a contract, possibly followed by prolonged start-up with intermittent interruptions or slow-downs thereafter, this opportunity for brief breaks contrasts with the tiring regimen of trans-Pacific travel.

Second, cultural compatibility provides a modicum of familiarity with Chinese signboards, food, and ambience. While this is often exaggerated in the West, the differences in behavior, lifestyle, and written language being considerable, it is nevertheless true that Japanese will find more in common as between their sense of "fit" in China than will American who go without any language preparation. Even the rather spartan accommodations are not too different from the cramped quarters which most Japanese have at home.

Third, the Japanese firm does not have to face problems of quarterly, semi-annual, and annual reports to anxious or angry stockholders as the China business goes into a decline or remains flat. This allows one to wait out the latest reforms in the Beijing bureaucracy or the sudden slowdown in orders as the result of fiscal retrenchment. Indeed the entire operation can be left on "hold" indefinitely in confidence that eventually the situation will turn around and those who have persisted will get their just rewards.

Fourth, the Japanese are familiar with conditions in China. Many of the senior executives and officials either worked there as civilians or served there as soldiers. Headquarters research staffs pore over Chinese sources of information, constantly updating their data base and correcting estimates as conditions change. On the spot studies carefully survey the situation with respect to supplies, resources, and market. Local Chinese contacts are developed and expanded as the situation requires.

In short, the Japanese entrepreneur sees China as sufficiently promising in the long run to be worth considerable short run investment in time, money, and effort.

Japanese Weaknesses

However certain disadvantages confront the Japanese businessman in China which offset the foregoing strengths to a certain extent, especially with respect to comparison with Americans. First and foremost is the heritage of history. It is impossible to exaggerate the bitter feelings with which Chinese of all generations view this heritage. The Nanjing Massacre of 1937 will be commemorated on its fiftieth anniversary next year as will the Marco Polo Bridge "incident" which triggered the Japanese war with China. The subsequent suffering of millions, the wholesale destruction of cities and countryside, and the further impoverishment of an already desperately poor society left a legacy of hatred that can only be overcome with time and major effort by both sides.

That effort is officially recognized by establishment of the Commission for Sino-Japanese Friendship in the 21st Century with General Secretary Hu Yaobang and Prime Minister Yoshihiro Nakasone as its chief sponsors. Yet despite this and other such efforts, resentment in China over dependence on Japan for economic modernization runs deep. In part this results from perceptions that Japanese are reluctant to apologize for past aggression and admit guilt for past atrocities. These perceptions are reinforced by official protests over Japanese attendance at the Yasakuni Shrine ceremonies honoring the war dead. They are also prompted by Tokyo's approval of high school history books that soften descriptions of military aggression and, in effect, deny the record of expansionism in Asia.

Both governments are trying to mitigate this problem. Their mutual handling of this year's controversy over a right-wing textbook, Nakasone's refusal to visit the controversial shrine in August, and his firing of his minister of education for extremely provocative remarks concerning Japanese imperialist aggression won favorable comment from Hu at the time and again during Nakasone's visit in October. But Japan is a pluralistic democratic society and provocations are certain to arise which are likely to trigger Chinese protests if not public demonstrations.

Under these circumstances it is not surprising that there is widespread distrust of Japanese businessmen in China. They reportedly underbid to win contracts and then charge high prices for spare parts and service. They are seen as trying to hold China back by refusing to divulge technical information or transfer key parts, thereby obstructing indigenous production and forcing continued dependence on Japanese sources. They allegedly are only interested in short run profits and will not invest in long term projects which are needed to help China modernize. They are believed to sell their highest quality products to the United States and Europe, using the China market for lesser grade goods.

These beliefs and rumors are not necessarily true, although there may be instances of one kind or another that can be recounted to illustrate them. On the one hand in 1985, some 7,000 Mitsubishi trucks proved seriously defective and the company had to take corrective measures, by which time publicity in the Chinese media made the incident common knowledge. On the other hand, it is virtually impossible to find anyone who will prefer to buy Chinese consumer goods if the Japanese counterpart is available, even if at a slightly higher price.

On balance, the negative images associated with Japanese business practices and with Japan as a past predator are outweighed by the positive aspects of trading with Japan, hence the country's pre-eminent position in the Chinese market. However the negative aspects do exist and open opportunities for other competitors, including Americans.

American Opportunities

The sharp rise in the yen and the corresponding fall in the dollar may be a transient phenomenon but while it lasts American products gain a significant advantage over their Japanese counterpart. This may not be true for those joint ventures already established which provide fixed amounts of Japanese investment but it opens the door for better American bids where prices of imported equipment and parts are important.

A more basic, long-term improvement lies in the potential role of American college graduates with training in business and the Chinese language. There are at least a dozen campuses where this combination of education is available with, at least until recently, some government language fellowships available. Unfortunately whereas such programs need to be expanded in funding because of rising tuition costs, especially in graduate schools, there is the threat of cuts in the wake of Gramm-Rudman and budget balancing commitments. Given the gross disparity in our trade balance, cutting government fellowships for Chinese and Japanese language study is truly penny-wise and pound foolish.

Nevertheless, there will still be a continuing supply of bright, eager, and hard-working young Americans capable of coping with the Chinese language, sensitive to Chinese culture, and willing to put up with the difficulties of doing business there. Moreover they are available at a much lower cost than the mid-level executive often chose for the job and they are less likely to have family complications. Indeed, having made the arduous and expensive effort to learn Chinese--usually a three to four year investment--they ar truly anxious to experience living there, particularly when it leads to career opportunities.

These young people share a quality with their older associates that is particularly appealing to Chinese, especially when compared with Japanese, namely a relaxed and friendly informality. Granted that the stereotypical back-slapping hearty-laughing American can overdo these and other mannerisms in any foreign country, including China. Yet the proper balance of politeness, tact, and sensitivity combined with an open, sociable personality makes Americans successful in fitting into today's China. This is an asset which should not be underestimated.

As one Japanese remarked to me, "In the past we have always been the student and China the teacher. Now it is reversed. It is not easy for Chinese to be the student and we are not very good teachers." Put more bluntly, during my interviews in China and Japan each side often characterized the other as "arrogant." It is dangerous to generalize about behavior but to the degree that such generalizations gain popular currency, they are politically relevant.

Last but not least, the investment of time, effort, and money in China now should pay off before too long, certainly in the next decade. European traders speak quite frankly of not expecting any returns before 1988-89 but are nonetheless making their rounds regularly to keep the door open for that eventuality. There is no mythical bonanza in China. The image of one billion consumers is wholly illusory. And in any event Japan is likely to be number one in trade for many years to come, perhaps permanently.

But this is a market that is certain to grow with ultimate returns greater than any in Asia, and depending on the product line, perhaps in the world. To get from here to there will require foresight and commitment, qualities which American enterprise will have to encompass if it is to succeed abroad.

Mr. ROMBERG. Thank you very much, Allen. Let us turn now to Melvin Rines.

STATEMENT OF S. MELVIN RINES, MANAGING DIRECTOR, INTERNATIONAL DEPARTMENT, KIDDER, PEABODY & CO., INC.

Mr. RINES. Thank you. I want to echo my thanks for being invited to participate in this panel by Chairman Obey and also for being part of this august group of economists, political scientists, and so forth.

As an investment banker, my view may be slightly different. My cast might be a little divergent from the previous speakers, but nevertheless, we will be coming down the same road and probably come to the same conclusions.

I think in order to answer the question that was posed by this symposium and the question: "The New China, is it a miracle or a mirage," one has to look back ever so briefly at the modern history of China to see where we've been, or where they've been more accurately, and perhaps where they are today and where they are going.

The chronology is all well known. As we do in fact recall from our readings there were a series of dynasties starting in 200 B.C. which ended in 1911 when Sun Yat-sen and his republican government came into power. That age with Sun Yat-sen ended in 1926 with his death and was taken over by Chiang Kaishek and the Nationalist Party and that continued on through to the Communist revolution in 1949.

During the 1911 to 1926 period, very little was accomplished in the way of moving toward an industrialized state or in fact doing much for the general welfare of the people. There was a great deal of controversy between rival warlords. There was a Western intellectual contest against traditionalists and really not very much could be accomplished.

Probably the best period of that time occurred in the late 1920's to 1932 when indeed industrial relations started to take place and in fact some of the reforms were filtering down to the people; 1932, of course, was the year of the recession. This was aggravated by the Japanese invasion in 1937 and, of course, the chaos of World War II.

That period, starting with the recession and really culminating in the Communist revolution success and toppling in effect of the power of Chiang Kaishek, resulted from the lack of progress, the lack of coordination, and the political fragmentation that occurred throughout that period.

In 1949, Mao Tse-tung came in in a country that was prostrate and we know very well the methodologies and the procedures that took place in moving it forward into the next few decades.

Initially, it was very successful. Heavy emphasis on industrial expenditures brought very rapid change. The growth rate moved up about 6.2 percent a year from 1952 to 1979 and the industrial component of that gross national product moved from 19.5 to 46 percent.

However, underlying this seeming progress were some serious problems that were developing and, needless to say, the rigid central administration was not responsive to some of the other more immediate methods of allocating credit, making decisions on product manufacture, and working through the societal reforms.

Gross inefficiencies developed. There were, as you know, the collectives and the communes and the brigades where the peasantry was organized in every manner of their lives. They had very little decisionmaking power, very few incentives, and in fact produced relatively very little.

By the time of the death of Mao Tse-tung in 1976 the country was ready for new reforms. The people understood—I should say the new leaders understood that in fact a new China had to be born. The new China, as we know, really started in 1977 under Deng Xiaping. This change was dramatic. It was precedent-shattering. No one was prepared to really understand what lay before the country in the next 10 years.

The changes were throughout the system. It was in the agricultural area. It was in the industrial area. And more recently, in the political area.

First, in the agricultural area, as we know, the reforms were in fact dramatic. Instead of having these collectives and these communes and brigades, they shifted over to the townships. They permitted the peasants to contract for land, to work beyond the assigned quotas, to be able to sell both to the government at higher prices beyond their assigned quotas and to market those surpluses in the incipient urban and rural marketplace.

The results were absolutely astounding. In the period from 1979 to 1984, grain production doubled; cotton tripled; farm income went up 100 percent. All of this had what we might well expect were fairly substantial changes and effects on the rural society.

This process was then, in 1979, also moving through the industrial sector. Necessarily, this could not be quite as dramatic. More things had to happen. More things had to be coordinated in order to have this move in the direction that the agricultural reforms had moved in. Nevertheless, the process has been relentless, the change has been constant, and the effort and every indication for the future seems to be that it will be continued.

The first start was with what was called special economic zones. This is sort of an experimental laboratory type situation where specific zones, generally around cities, were created and in those zones special dispensations were made for businesses coming into that area, such dispensations as lower or no import taxes for raw materials brought in for the manufacturing during that period of time, the ability to hire and fire workers, the ability to get foreign exchange, and very low corporate taxation, some 15 percent.

Again, as you might expect, this was like a breath of fresh air and in fact did bring forth increased production, increased business investment, and increased incentives on the part of the Chinese people.

However, it also brought forth some of the other things that go with freedom—the ability to create a black market, the ability to cut corners, and the abililty to do some of the things that either border on or are in fact illegal. Some of these things did occur in the first and most successful special economic zone in 1984. I believe it was Deng Xiaping who indicated that this huge success that was occurring in the special economic zones might have to be revisited and perhaps revised.

The reality is, however, that they did not really change the process. They did make some adjustments. They cut back their four special economic zones. They set up 14 cities which were so-called open cities which tracked some of the advantages and benefits that were allocated to the SEC's as they're called. Some of this was backtracked, some of it was stretched out, but the policy still remained the same.

Beyond these special economic zones throughout China, again, experiments were being made in the industrialized area to improve and to become more modern and perhaps be able to compete better in these areas.

Such changes as, in 1979 there was a joint venture law that was put into place. It truly was precedent-shattering. It did allow foreigners to own jointly with Chinese counterparts. They could build buildings. They could create factories and they could move forward in the commercial area.

As important as that was, however, it also brought with it all the problems that you might expect in an emerging situation where they also imposed rules on how a company could be set up, even to the point of how many directors had to be Chinese, how many had to be Americans if we're talking about the American process. They retained the right to hire. They retained the right to fire. They retained the right to determine when and what organizations would get the raw materials, and certainly the foreign exchange capabilities and access were constantly monitored and restricted.

The problems were great and their successes were few or little. The number of joint ventures during this period from 1979 to 1983 was a grand total of 200. Most of those were tortuous, painful, and in many cases, not very successful after they got into operation.

In 1983, there was what was called a much longer name but the implementing joint venture regulations which went much further in terms of meeting some of the objections, some of the problems that occurred in the past, such as giving more flexibility in terms of the types of businesses that could be conducted, giving more flexibility in management, but still retaining such things as the ability to hire and fire, the methodology of evaluation of properties, and all the rest.

For example, one of the things that you might imagine a joint venture by necessity requires is that you have a joint venture with the State, the State owning the land, the State owning the companies, so that you become in effect a partner with the State. It's not easy to discuss contract terms or to change directions when you're in that situation.

These problems again were recognized and well described. We heard all about it in our own press and it culminated in really landmark proportion legislation this year. This spring there was a new law that was put into place whereby some of these projects and enterprises could be wholly owned by a foreigner. There were one or two SEC's that had been wholly owned before but none really of any consequence throughout the country. This is truly landmark because it does permit, again, an American company if it desires to set up an enterprise and it also has going with it a great deal more flexibility in terms of the hiring and firing, wage negotiations, valuations of property, and so forth.

Perhaps more meaningful, although it's too soon to tell, as of October 11 of this year, some of these implementing regulations were moved forward in new provisions and this went even further in terms of releasing the opportunity to manage your own business in a way that we would think in our terms was modern, scientific, and competitive.

Such things were delineated—for example, it's striking—in my paper I select a couple of articles to show a tracking of how this change has occurred. For example, in evaluation of land and property, you can imagine how difficult it might be to try to set evaluation, if they're pooling land and property and you're pooling hard dollars, to judge exactly what the value of that property is. Obviously, there's no market over there. There's nothing to look at that's comparable. And so it really was a question of hard negotiation with the State.

The latest provisions have very definitive guidelines on what the valuation has to be, not only in the countryside but in the city, and the range is very narrow and it also said—one of the things I enjoyed seeing was that there is a specified period of time by which the government bureau has to respond to a petition for approval. So great changes have been made in this area, that I think, again is terms of the effect, the growth rate has gone up again very dramatically, 6.2 versus 3.2 in the previous 5-year period. I think it augurs well for the future that these things have happened and occurred as quickly as they have.

Looking down the road to what needs to be done there and where it might be going and tracking perhaps a few areas that would be more in by bailiwick than perhaps some others, number one, in terms of the legal aspects of creating financings and being able to get deals done, there are still a number of areas that obviously need work, not surprisingly.

For example, as we all know, when everyone greeted the opening of China as the stirring of a great giant and the ability to have these huge markets opening up, the disappointment was quick and dramatic. One of the reasons for these misunderstandings was that we were not used to the different concepts that they have in terms of what is an agreement and what is a contract, what's binding absolutely and what is more a letter of intent in terms of our filings. So there does need to be some definition in that area.

The contract terms have to be more specific. They seem to like them vague. They think it creates flexibility. We know from our experience that it creates conflict. The ability to perfect security interests which is vital to our financing in this country and most of the modern countries really isn't there yet. The reason is that most of the security belongs to the State and it hasn't been set up with the kind of clarity that you need for an investor to be confortable that if something goes wrong he can go in and get his collateral and bring it out.

The bankruptcy law—a law was recently passed. There was great controversy in trying to put it together. It's there but it isn't implemented because a number of other things have to come into place before it can be worked out.

All of these things may seem as though they're slow, that we're critical and all that, but I think that when you look back for a moment and see where they've come from you can recognize the great progress they've made.

For example, the lack of bankruptcy law—how can you do business without having an opportunity to have something happen in the event of default, though when you think about it, there were no defaults; there were no failures. All businesses continued. The first failure occurred on August 3, of this year. So there was not need for bankruptcy law in their terms.

In terms of perfection of security interest, how do you assert a claim against the State if you don't have the legalism involved in setting forth? So it's not surprising that these things were not in place.

Moving in to the financial area for a moment, again, we know of these tremendous goals for the year 2000. Certainly if they are to be realized, huge amounts of capital have to flow into the country.

In terms of numbers—and I can't really claim that these are hard numbers—they're moving targets in a way—I understand that they are talking about something upward of $40 billion in the next 5 years of capital inflows. That would be up from $21.3 billion in the last 7 years, so it's a major increase.

Part of this has to come from borrowing. They've been in the capital markets around the world somewhat tentatively, but they are in. They come in primarily not really political subdivisions, more like agencies or authorities of the central government. The Bank of China, for example, has borrowed some $1.4 billion. CITIC, China Industrial Trust & Investment Corp., about $700 million, and some other specialized borrowing corporations another total of about $400 million.

These amounts have come primarily from Japan and have been financed primarily in yen, although there have been a couple of Eurodollar issues done in Europe and a deutsch issue out of Frankfurt. To date, they have not accessed the U.S. market. In order to do that, as many of you know, our U.S. market here is the most difficult to access, primarily because of our very careful regulations and the carefulness and definitiveness with which our investors look at securities and the need to have ratings.

As far as ratings go, it's going to be very challenging for them to get U.S. ratings. Bank of China has been rated AAA by Japanese rating agencies and CITIC AA by the same agencies. The U.S. agencies run their own course, they do their own research, and they are not very much persuaded or influenced by outside rating agencies.

I think when you look at the credit of some of these entities you have to look through it to the sovereign credit of the People's Republic itself and there are some seemingly almost irreconcilable discrepancies and contradictions.

For example, how do you look at a country of per capita income of under $400, which is lower than many developing countries, but that same country has production much greater than many of our industrial countries? How do you look at a country that has a per capita debt that is almost infinitesimal, but the debt-service ratio—the debt-service that they have to pay relative to export earnings and their debt-service to total revenues which are very small indeed, but it's very small because the borrowings are very small and the population is very large. So the rating process is going to have to be done very carefully. It's going to have to be done with lot of comparative analyses, interpretations and all the rest beyond the use of statistics in order to get the kind of rating that I think they deserve.

Looking at the need to register in this country, it probably will not be difficult if they can be assured that they are going to have what's called schedule B exemptions, which are exemptions allowable to sovereign credits. Clearly, these have to be considered sovereign credits and are in the marketplace around the world, but when you look at the underlying documents, their charters, some of the legal processes by which they are established, they give a lot of indication of being independent authorities and agencies. This clearly would have to be made bullet-proof in terms of the U.S. investor and U.S. legal opinions before they could be effectively sold in this country.

Summing up some of these areas that we've talked about and looking at where we go from here and where is the country, it is really a miracle or is it a mirage, I think there's little doubt that what we've been witnessing in the last 10 years is a veritable miracle.

Who could have said 10 years ago that you would see the country moving in the direction it's going, much less made the progress that it has? I think the question really is, is this change that we've seen real and is it durable? I think that moves us a little bit into the mythical situation. Certainly from the economic standpoint, it's hard for me to believe that despite all the problems, despite all the bad press, despite all the painful experiences, that interest from the business standpoint will decline. We've all known I guess in spades how difficult it is to do business there, but I think we might step back for a moment and think what a U.S. businessman has to do to start a business in the United States when he has to go up against zoning requirements, environmental impact studies, if it's a tall building where the shadow is going to fall when the sun shines in various seasons and so forth.

Certainly doing business in Japan can be equally difficult and sometimes more difficult.

So I think that those areas will not deter businessmen from around the world from trying to develop enterprises there. I think that further, from a political standpoint, as it was alluded to earlier, there have been some changes. No longer, according to the constitution, can these people be in office for life, 5-year terms for the premier and vice premier and so on. There have been some local elections. There is evidence that the party and the administration may be splitting off a little bit in terms of the interactions that they've had for all these years. So I think there is hope that all of this is real.

I think in terms of where it's going, whether it will continue, I think we have to believe that the momentum is tremendous. You've got 1 billion people who are thinking, living, responding to their leaders substantially differently from the way did a few years ago. I think each day that goes by this becomes further embedded.

I think that each day new changes are coming in and it's my belief that these changes are real, that they are durable, and it is not a mirage and it is, in fact, a miracle. Thank you, very much.

[The complete statement of Mr. Rines follows:]

Presentation
to the
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Symposium

"THE NEW CHINA: MIRACLE OR MIRAGE?

by

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THE NEW CHINA: MIRACLE OR MIRAGE?

To address this question effectively, it is necessary to review briefly the modern history of the "old" China. The chronology is well known: The last of a series of dynasties dating from 202 B.C., the "Qing Dynasty", ended in 1911. It was replaced by the Republic of China, with Sun Yat-sen as its president. The leadership of the ruling Nationalist Party which he founded was taken over after his death in 1926 by Chang Kaishek who remained in power until his armies were defeated by Communist forces in 1949. On October 10, 1949, the People's Republic of China was established under the leadership of Mao Tse-tung who ruled until his death in 1976. The "new" China in the context of this symposium was born in 1977 when Deng Xiaping came to power and shortly thereafter initiated the "opening" of China.

The early years of the republican movement under Sun Yat-sen were marked by continuous strife between newly Westernized intellectuals and conservative officialdom on the one hand and between regional warlords for control of land and tax revenues on the other. Little was accomplished toward improving the lives of the people or the economy until the period between the mid 1920's and the early 1930's. During this time considerable growth occurred in industrial and agricultural output and some progress was made in the underlying social structure. The beginnings of an industrial state were emerging. However, economic progress was interrupted by the worldwide depression in 1932 which was followed by domestic political fragmentation and social upheavals emanating from the Japanese invasion in 1937 and World War II. No meaningful progress in economic development occurred during this period under the Nationalist government and it fell to the Communist revolution in 1949.

The People's Republic of China, under Mao Tse-tung, experienced rapid industrial development due to high rates of investment in heavy industry and gradually moved away from a predominantly agrarian economy. National income averaged growth of approximately 6% per year between 1952 and 1979 with the industrial component growing from 19.5% to approximately 46%. This growth was uneven, however, and lacked balance between heavy and light industry in particular and between industry, agriculture and services (which were practically non-existent) overall. Added to this lack of balance were periodic economic and political upheavals such as the Great Leap Forward of 1957-58 with its disastrous economic consequences and the Cultural Revolution of 1965-75 which devastated Chinese society and left long lasting human and cultural scars.

Throughout this period, despite the apparent economic progress cited earlier, there was an underlying deterioration in productivity and efficiency and a failure to keep pace with the modernization of societies in the free world. Overplanning, centralized administration and the determination to achieve self-sufficiency had the corollary disadvantages of lack of incentives, bureaucratic inertia and reduced interaction with other economies. The collectivization of the rural economy, with its communes and brigades as the basic production units lacked individual incentives and simply failed to work over time. The centralized management of industry and investment insulated from market forces, proved unresponsive to change and discouraged individual initiatives. The development and use of modern technology was sporadic and was generally confined to activities sponsored by the central government such as military and space activities. It was clear to the new leaders taking power in 1977 that new policies, new programs and indeed a new China was needed.

Agricultural Reform

Much has been written about the rural reforms instituted by the government in 1979. Communes were eliminated and the individual farm family became the basic agricultural production unit. Prices paid by the State for produce were increased substantially for assigned quotas. Above-quota production could be sold to the State at still higher negotiated prices or sold directly to emerging rural and urban markets. Although the ownership of land was retained by the collectives, each household was allocated a specific plot based largely on the size of the family and was permitted to contract for more. Households were allowed to select and buy their own tools and implements. Contractual arrangements for setting quotas, acquiring additional land, raising farm animals or engaging in other specialized activities were established and the terms were gradually refined and lengthened. Tax payments to the collectives by the households of a portion of revenues rather than contributions of labor in lieu of revenues allowed the family to build excess income for investment in additional equipment or land, or for savings. In short, the elements of a market based agricultural economy were in place.

The results were outstanding. The annual rate of growth of agricultural output increased to 9.2% in the period 1979 - 84 up from 3.2% in the previous five year period. Grains and cereals production increased more than 22%, sugar by 50% and cotton production nearly tripled. A comprehensive survey showed household farm income increased over 100% leading to significant changes in the rural social structure. Although food production declined in some areas due to natural disasters (floods and droughts) in 1985, overall China with the world's largest population, became a net exporter of food.

Industrial Reform

As noted earlier, China's industrial system since 1949 had been characterized by rigid centralized planning and administration. Selection of products to be manufactured, plant sites, prices, allocation of materials and credit were all determined by the state. Overall priorities for investment in major sectors such as energy, heavy industry and transportation were set by the central government and the ministries concerned were expected to meet assigned production goals. Manpower was allocated, whether skilled or unskilled, and wages and benefits were established by the State. There was little local autonomy, few incentives and almost no private enterprise.

It should be noted, however, that despite the rigidities of central planning and the periodic political and economic upheavals, much progress occurred during the years 1949 - 78, especially in heavy industry. But by the late 1970's reduced productivity, misallocations of resources and lack of technological change created such imbalances and inefficiencies that the need for reform became imperative. As in the rural sector, the stage was set for meaningful change and the forces supporting such change were in place.

Special Economic Zones (SEZs)

In 1979, in order to experiment with industrial reforms and to test various incentives for attracting foreign investment, the first Special Economic Zone was established. Such benefits as selected import and export tax exemptions, low corporate taxes, freedom from most foreign exchange restrictions and incentive-based wages were provided to a wide range of enterprises within the zone. The result was almost explosive growth in commercial activity and a general acceptance of the concept. Over the next few years, three more SEZs were created and fourteen cities were designated as open cities and given many of the same incentives with which to attract foreign investment.

However, in 1984 serious mismanagement problems were uncovered including some illegal activities which forced major corrective action and a slowdown in growth. The fourteen cities were reduced to four and their programs were adjusted and lengthened. Some restrictions were imposed on the types of enterprises allowed with increased emphasis placed on those in advanced technology and infrastructure. Nevertheless, support for the SEZs was unwavering and they continued to prosper and grow and many of the lessons learned were incorporated throughout China.

In 1979, steps were also taken in limited areas beyond the SEZs. Selected State-owned factories were given local control over production, marketing, manpower and prices. Taxes were paid and profits were permitted to be earned and retained for reinvestment or incentive bonuses. The results were immediate and very favorable and led to a broadening of reforms among other enterprises and increased support for more change throughout the industrial system. However, such changes were not easily absorbed. They required new concepts, new skills and new relationships and a huge reduction in bureaucratic authority. Managers had to learn to compete, take risks and innovate.

Opponents, many of whom were losing power, were always present to criticize success and welcome failure. And many felt that the rate of change was too rapid and should be slowed down or reversed lest it get out of control.

Nevertheless, the initial experiments were clearly successful and were soon followed by further reforms in 1982 and in 1984. Although central planning, pricing and allocations of materials and credit remained in some key areas, voluntary guidelines, flexible pricing and allocations by market forces were adopted in most other areas. Today greater autonomy and control is being pushed down to the province, district and city levels and a major restructuring is underway to meld socialistic tenets with pragmatic capitalism. Much progress has been made and more is being made but daunting challenges remain.

China Today

The opening of China has been likened to the stirring of a sleeping giant and generally calls forth visions of massive construction of new industry, development of huge markets and rapid technological change. In fact, the analogy is not far off but the realization of many of those visions must await the future.

China, a country with over a billion inhabitants living on 1/15th of the world's total land area and with vast natural resources had been virtually closed to the outside world for almost thirty years. During this time information on its economy was sparse, very little communication with the outside world occurred and almost no trade was conducted. As the world moved forward in such areas as computer technology, electronics and consumerism, China stood stolidly by. Its people for the most part lived as their parents before them, worked as they worked and changed little. Small wonder that the potential pent-up demand for goods and services, real and imagined, made Western businessmen euphoric. As we all know the initial enthusiasm on both sides was enormous and resulted in tentative commercial agreements far beyond the capacity of China to fund or for the economy to absorb. Foreign goods and services require foreign exchange to pay for them and foreign exchange can only be obtained through exports, foreign investment and borrowings. It therefore became clear that many of the agreements were premature, that export markets had to be expanded, foreign investment in China had to be encouraged and access to capital markets had to be developed.

The Emergence of Joint Ventures

Since all land, factories, businesses and natural resources were State owned, foreign investment in almost any enterprise, by necessity, became a joint venture with the State. The legal basis for such ventures was established in 1979 in the "Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investments". This law which shattered all legal and socialistic precedent at the time set forth in general terms the types of ventures which were considered desirable, the business organization and labor arrangements which were permissible, negotiating guidelines to be used on land valuations and prices and State approval procedures. The specifics of such terms were left vague with the result that each venture became unique in its ultimate form and the negotiations to reach that stage were invariably long, tortuous and often unsatisfactory. Although the joint venture law was greeted with great enthusiasm and many preliminary agreements and arrangements were entered into, less than 200 equity joint ventures were completed during the 1979 - 83 period. Moreover, many of these proved to be difficult to create and operate due to differing interpretations of contract terms and the inevitable incompatibility of many management practices and work rules with Western custom. Nevertheless, much was learned on both sides which led to the promulgation of the "Regulations for the Implementation of the Law of the People's Republic of China and Joint Ventures using Chinese and Foreign Investment" on September 20, 1983. These regulations went far beyond the initial legislation in defining procedures, establishing levels of authority and setting forth definitive rules for the organization and management of an enterprise. Guidelines were established for the valuation of tangible contributions (in lieu of non-existent market values) such as land and operating facilities, and labor relations were determined and regulated by the State in accordance with the trade union law. The beneficial effects of these regulations were quickly reflected by the acceleration of equity joint venture completions which grew more than threefold during 1983-84. By June 1986 equity joint ventures totalled more than 2000 and all joint ventures, wholly owned foreign enterprises and joint explorations combined totalled 6700.

Despite the progress made both in defining and regulating joint ventures many difficulties remained and many complaints were heard. Valuation guidelines proved to be too broad to prevent unreasonable negotiating demands, and wages, work rules, hiring and dismissal prerogatives were beyond the control of management and fostered inefficient and costly operations. Taxing authority was ill defined and abuses arose. And the approval process was still cumbersome and very time consuming.

As experience was gained and criticism mounted many improvements were studied and evaluated. In 1986, this process culminated in new legislation and a new set of regulations of landmark proportions. The "Law of the People's Republic of China on Enterprises Operating Exclusively with Foreign Capital" was adopted on April 12, 1986 at the Fourth session of the Sixth National People's Congress and "Provisions of the State Council of the People's Republic of China for the Encouragement of Foreign Investments" was promulgated by the State Council on October 11, 1986.

The new law provides the opportunity for foreign investors to finance, own and manage an enterprise entirely on their own. Although the type of enterprises and the purposes for which they are permitted are narrow (high technology, export oriented, etc.) the advantages of avoiding the many joint venture complications and requirements are great and the potential for the extension of this concept in the future is bright.

The promulgation of new provisions which cover both joint ventures and wholly foreign-owned enterprises reflect the determination of the State authorities to streamline and improve the process for foreign investment in China. The substance and magnitude of the changes and the definition employed clearly are in response to lessons learned and criticism levelled in the past. This can perhaps best be illustrated by comparing articles in the implementing joint venture regulations of September 1983 with parallel articles in the new provisions of October 1986. For example, the generalities of Article 49 on site use fees under the 1983 regulations contrast sharply with the specifics of Article 4 of the new 1986 provisions on such fees:

Article 49 (1983 implementing joint venture regulations).

> "The standard for site use fee shall be set by the people's governments of the province, autonomous region or municipality directly under the central government where the joint venture is located according to the purpose of use, geographic and environmental conditions, expenses for requisition, demolishing and resettlement and the joint ventures requirements with regards to infrastructure, and filed with the Ministry of Foreign Economic Relations and Trade and the state department of land."

Article 4 (the 1986 new provisions)

> "The site (land) use fees for Export Enterprises and Technologically Advanced Enterprises, except for those located in busy urban sectors of large cities, shall be computed and charged according to the following standards:
>
> (1) At Rmb 5 to Rmb 3 per square meter per year in site areas where the development fee is computed and charged together;
>
> (2) At not more than Rmb 3 per square meter per year in site areas where the development fee is computed and charged on a one-time basis or areas which are developed by the above mentioned enterprises themselves.
>
> Exemptions for specified periods of time from the fees provided in the foregoing provisions may be granted at the discretion of the local people's governments concerned."

and the parallel articles reflecting substantive changes in regard to management and labor relations;

Article 91 (of the 1983 implementing regulations)

> "The employment recruitment, dismissal and resignation of staff and workers of joint ventures, and their salary, welfare benefits, labour insurance, labour protection, labour discipline and other matters shall be handled according to the Regulations of the People's Republic of China on Labor Management in Joint Ventures Using Chinese and Foreign Investment."

Article 15 (of the 1983 new provisions)

> "The people's governments at all levels and relevant departments in charge shall guarantee the right of autonomy of Enterprises with Foreign Investment and shall support Enterprises with Foreign Investment in their respective management in accordance with international advanced scientific methods.
>
> .... (such Enterprises)...... have the right to determine their respective wage levels, the forms of wages and the allowance system.

> .... (such Enterprises)........ may independently determine their own organizational structure and personnel system, employ or dismiss senior management personnel, increase or dismiss staff and workers."

The ultimate effectiveness of the new law and the new provisions must of course await actual operating experience and results but the intent and the direction of these policy changes by State authorities are clear.

Legal Considerations for Investment in China

An essential ingredient for continued economic progress for the new China is the formulation of a comprehensive and effective body of business law. Such areas as contract law, bankruptcy law and the perfection of security interests are integral to the economic fabric of a modern industrial state. Clearly the construction of appropriate laws and their integration into the social system is complex and the necessary experience and building of legal precedents will take time. Although much has been accomplished since 1979, there are some areas which still need to be improved:

- The distinction between agreements and contracts in meaning and execution is less defined than in the Western world and often leads to serious misunderstandings. The concept of what is binding and what is merely intent would benefit from greater clarification.

- Contract language tends to be less precise than Westerners are used to ostensibly to encourage flexibility and to provide for change. However, there is growing recognition that many problems can be avoided by greater precision in drawing contracts.

- There is no legal "roadmap" for determining the criteria to be used or the procedures to be followed for enforcement of contract terms or for the resolution of disputes.

- A legal framework for perfecting security interests and the process by which they are invoked needs to be developed.

- The implementation of the recently passed bankruptcy law should be expedited.

- Further development and refinement of arbitration and litigation processes should continue to be emphasized and integrated into the legal framework.

Although it is easy to be critical of the present legal system, it is worth remembering that only a few short years ago there were almost no meaningful laws in the business area and the socialist system in place essentially precluded their formulation. As important as bankruptcy law is today, for example, it was quite unnecessary and even difficult to contemplate when all enterprises were owned by the State and none were allowed to fail. Or in regard to perfecting security interests, how would an investor go about asserting a claim against collateral which belonged to the State? Despite the progress made and because of the problems of implementing further change, meaningful foreign investment in Chinese credits other than those engaging the full faith and credit of the State will be dependent on further definitive progress in this area.

Financing the New China

The ambitious goals set for the year 2000 and the rapid economic growth and development necessary in reaching them will require unprecedented amounts of capital to finance. New means must be found to increase internal savings and investments and the continuing efforts to encourage investment from abroad must be pursued vigorously. In addition, short-term commercial funding facilities and capital market borrowings must be dramatically increased.

Due to new profit making opportunities in both the agrarian and industrial sectors, along with current restraints on consumer spending, savings are growing rapidly. New institutions through which these savings can be channeled and a variety of instruments with which they can be employed are beginning to emerge. The banking system is being expanded and reorganized and extended into smaller cities and towns and rural areas. Some rudimentary security issues of bonds and preferred stock are being devised and incipient markets in which to trade them are developing. An insurance industry is growing in its ability to cover risk and as a repository for savings.

Despite these progressive steps, much more remains to be accomplished. Organizationally the establishment of the People's Bank of China as a true central bank and the restructuring and realignment of specialized banks and financial institutions below it has been a major reform. However, functionally the appropriate regulation and control systems are not yet in place to assure the responsive management of monetary aggregates, the effective mobilization and direction of the flow of funds and the efficient utilization of such funds throughout the system. Continuing efforts to transform banking and other financial institutions into more independent enterprises along with meaningful incentives to provide services and to perform are very important. Greater reliance on market forces in determining interest rates, savings flows and allocations of credit are needed. The effort to develop mechanisms for interbank lending and new instruments for commercial paper and other debt issues, with markets to trade them, must be maintained. Above all, the current hard questioning, unrelenting search for answers and willingness to innovate and experiment must be continued. By any measurement, the magnitude and pace of change in the financial area is impressive and augurs well for the future.

It has been estimated that total inflow of foreign capital in China will approach upwards of $40 billion over the next five years. The magnitude of this estimate is apparent when compared with the total inflow of foreign capital from 1979 to 1985, a period of seven years of $21.7 billion. To reach this estimate an increase in capital market borrowings and a broadening in capital market access will be required. China borrows in the capital markets through various political subdivisions all of which engage its sovereign credit. The China International Trust and Investment Corporation ("CITIC"), an investment and merchant banking arm of the government was the first entity of the People's Republic of China to borrow in a capital market when it launched a 10 billion yen issue ($50 million equivalent) in Tokyo in 1982. Since then it has borrowed the equivalent of approximately $700 million in various currencies through October 1986. The Bank of China which has the primary responsibility for foreign exchange activities has borrowed the equivalent of $1.4 billion in various currencies through the same period. Approximately $400 million was borrowed by entities such as Fujian Investment and Enterprise Corporation and Shanghai Investment and Trust Corporation which also engage the sovereign credit.

The Bank of China and CITIC have been assigned AAA and AA ratings respectively by Japanese rating agencies. Their eurobond issues, although not formally rated, trade at spreads comparable to these Japanese ratings. No ratings have been requested of or assigned by United States rating agencies.

Although China's credit has been well received in both the Japanese and euromarkets, it is clear that access to the U.S. market will be necessary to meet the huge borrowings projected in the future. To gain such access the issuer will have to obtain ratings from U.S. rating agencies on each issue and file a registration statement with the Securities and Exchange Commission.

The rating process in the U.S. is comprehensive, lengthy and complex. A wide array of descriptive information and economic data are required along with detailed analyses of relevant credit criteria. Since no issuer's debt can be rated higher than that of the country in which it is domiciled, the sovereign credit becomes an integral part of the rating process.

Because the opening of China has occurred so recently, changes have occurred so rapidly and the evolving economic system is so unique, the presentation of economic data and comparative analyses will be critical to the understanding of its credit by U.S. rating agencies and investors. It will be important to reconcile such seeming economic contradictions as a per capita income of less than $400, (a level below that of many developing countries) with a ranking above many industrial countries in industrial output. It is important to note that China is the world's leading producer of grain and cotton and among the world's leaders in the production of coal, chemical fertilizers, iron, steel and cement. Industrial production represents more than 45% of gross domestic product which is far above the average of developing countries and higher than most industrial countries. Unlike most countries, both industrialized and developing, China's task at present is to manage and often restrain growth rather than trying to develop and stimulate it. Also, unlike most countries, the living standards in the rural economy compares favorably with that of city dwellers, thus largely avoiding the disrupting aspects of large scale urban migration.

In the financial area such ratios as debt service to export earnings, debt service to total revenue and, of course, debt per capita are unusually strong due to the relatively small amount of debt outstanding (and the huge population). The outlook for inflation, for balance of trade and for overall balance of payments equilibrium appears favorable especially based on past experience. The ability of the State to control consumer demand while building the domestic supply of goods and services and restraining imports has been very important in maintaining a balance between exports and imports. The effective action taken this past year to curb demand in response to increasing inflationary pressures and a large trade deficit in 1985 was an excellent example of this control. In short, the credit judgment of both the rating agencies and investors will be heavily dependent upon their interpretation and weighting of esoteric and often conflicting data and on an appreciation of China's uniqueness as well as on the customary statistical information.

Registration with the S.E.C. should pose no problem as long as the issuer qualifies for a Schedule B exemption under the Securities and Exchange Act of 1933. This exemption is available to the People's Republic of China and to those political subdivisions clearly engaging its full faith and credit and permits the much shorter and less restrictive filings available to sovereign credits. Although it seems clear from the social and political structure of China that the political subdivisions do in fact engage its credit, it will be important to insure that the underlying charter documents and legal history confirm this fact. A legal review and possibly clarifying legislation may be necessary in some instances.

At present, there is a legal impediment to issuing debt in the U.S. due to litigation involving the default of a railroad bond issued in 1911. Holders of these bonds have made the legal claim that the People's Republic of China must assume the financial obligation of this debt. An examination of that claim shows the terms and circumstances of the issue and the legal factors involved do not support such a claim. Moreover, in 1984 a U.S. district court ruled against the claimants and a subsequent appeal to the 11th Circuit Court of Appeals was denied earlier this year. A petition to the U.S. Supreme Court was recently entered but it appears very unlikely that the earlier decisions would be overturned. Although financing in the U.S. is not precluded by this litigation, any financing will probably await the final resolution of this matter.

In Summary: Miracle or Mirage

There can be no real doubt that the world has been witnessing a veritable economic miracle in the opening and subsequent changes in China. Few, if any, could have predicted either the direction or the magnitude of these changes ten years ago. The real question posed in this symposium is whether China will continue in its present direction and whether or not these changes will endure.

Certainly miracles can turn into calamities and economic policies of political leaders can be reversed by those leaders or their successors. Indeed, many of the changes were initially met by active opposition which is sure to continue and may grow if new problems arise. The "miracle" has also had its critics from abroad, as well. The world's press has carried many stories about the difficulties of establishing business and trade relations, organizing and executing joint ventures, dealing with labor, and acquiring sufficient foreign exchange. Examples of long delays due to bureaucratic and regulatory complications are often cited and the high cost of doing business and paying for facilities and manpower are frequently described.

Much of the criticism has been well founded, and has been heard by the government and responses have been made. The rapidity with which regulations and practices have been adjusted in recent years reflects the State's determination to meet problems as they are identified. It should also be noted that perhaps there is the tendency for Westerners to expect too much, too soon. Business ventures in the United States, for example, have also suffered from bureaucratic and regulatory complications as businessmen dealing with zoning approvals, environmental clearances and trade union negotiations can attest. And many of the difficulties associated with Chinese practices and regulations are equaled or exceeded in Japan. It is not likely therefore that Western businessmen will become discouraged or that the direction of change will be reversed because of an absence or large reduction of foreign investment.

Although most of the above has dealt with economic change, it is important to note that significant progress has occurred in the political sphere as well. The personality cult under Mao Tse-tung has given way to a more democratic regime with more emphasis on the rule of law. Direct elections are permitted at the local level and the representatives elected can be replaced. Life tenure for State and

Party leaders no longer exists; the President, Vice President, Premier and Vice Premiers are limited to two consecutive terms of five years each by the Constitution. The interaction between the Communist Party and the administration has been altered and some separation between them is being considered. Perhaps equally important is that these changes have received support beyond the immediate leadership and are being implemented and administered by younger, well-educated and reform-minded Chinese who are slated to succeed to leadership posts.

The momentum of change is tremendous and touches the Chinese people at every level and in every endeavor. The way in which one billion people live, think and respond to their leaders is substantially different from what it was just ten years ago. Each day past changes become more imbedded and new changes are incorporated. And each day the possibility that these changes will be reversed recedes.

In summary, I believe that the new China is not a mirage but is in fact a modern miracle; and if present political and economic trends continue, and I believe they will, its future is unbounded.

Mr. Rines is currently a Managing Director, International Department, Kidder, Peabody & Co. He has over 30 years experience as an investment banker in public, corporate and international finance. He has co-authored major research reports on the Inter-American Development Bank (1980), Asian Development Bank (1983), African Development Bank (1984), and World Bank (1985). He is co-editor and a contributing author of the book The Supranationals published by Euromoney Publications in April 1986. Mr. Rines is an Adjunct Professor at American University and is currently teaching a graduate level course on international capital markets.

Mr. ROMBERG. Thank you, very much. I'd like to remind people that we are going to have questions and that if they have questions during the course of Roger Sullivan's presentation if you would raise your hand the committee staff will pick up cards and so on.

STATEMENT OF ROGER W. SULLIVAN, PRESIDENT, NATIONAL COUNCIL FOR UNITED STATES-CHINA TRADE

Mr. SULLIVAN. Mr. Rines mentioned this was a distinguished panel of economists political scientists, and so forth. You've heard from the economists and political scientists, and I am the "and so forth."

When I was invited to participate I was struck by the title: "The New China—Miracle or Mirage?" There are elements of both, elements of tragedy and farce and there are all kinds of titles we could have dreamed up. But I guess I would lean in the direction of miracle if we follow Chairman Obey's advice at the beginning and leave out theology and define "miracle" simply as something that's unexpected or something that people were surprised to see happen. I think both the cynical and the euphoric have taken a much more realistic view of China in recent years. We've stopped using the expression "China will never. . ." which was very popular for a while, such as "China will never allow foreign investment; China will never borrow money; China will never run trade deficits as a matter of national policy"; which by the way they are doing this year and will for the next year and the next 4 years, a dramatic change. "China will never reform its economy; China will never be able to generate significant export earnings; China will never become self-sufficient in food." So I think we have to be very careful about talking about the future in absolutes about China.

Even in the last year, which was supposed to be a disaster, it turned out to be not too bad at all. The big reduction in trade that everyone predicted last year did not happen. As a matter of fact, China's exports went up 15 percent in the first 9 months of this year despite the significant drop in oil prices and so-called protectionism that supposedly blocks China's earnings in textiles.

Their imports were slowed significantly, as they had hoped to be able to do. Their imports increased by only 5 percent. As Nick Lardy mentioned, their economic growth rate has slowed down. I'm sure that he didn't mean to imply that that was a bad thing. That's a good thing. It was planned.

As a matter of fact, let me say, I've been at many forums with Nick Lardy and with Allen Whiting and I generally agree with what they say and I think, to the extent I do disagree, it's often a matter of hoping they are wrong but fearing they're probably right.

I did disagree with a few things that both of them said, but not with a great deal.

I agree particularly that it would be unwise and incorrect to try to project from what could be legitimately described as a miraculous performance of the Chinese economy in the trade sector over the last several years to the future.

The Chinese have done a lot of things in terms of reform but they have also done a lot of the easy things. It's getting much more difficult to do some of the things that are required and much more controversial politically in China to do them.

So rather than try to predict what the size of the Chinese economy is going to be in the year 2000, since I'm not an economist anyway, or even the size of its trade or the level of our participation in it, I thought it might be more useful to look, as my colleagues have, at some of the obstacles in the way of China's economic development and some of the obstacles to the full realization of our commercial potential in China.

On the Chinese side, clearly the most important need is to continue the process of economic reform. Most Chinese officials agree with that statement. I think I agree with Nick Lardy that this question of knowing what you have to do and being able to do it politically are two different things.

I would say the two major outstanding issues for reform of the economy really come down to bureaucracy and to various issues surrounding the bankruptcy law. I think I might disagree with Mr. Rines; the bankruptcy law is not unimportant. I think it's a litmus test of reform in China, that if you don't have a bankruptcy law that means—and the Chinese, interestingly enough, in their debate over the bankruptcy law conceded this in their public debate—you really don't have a system in which you can legitimately make the manager of an enterprise responsible for profit and loss and you really don't have an economy which is responding to market forces. But most particularly, if you don't have a bankruptcy law, then you have the same problem the Eastern Europeans ran into when their reforms came to a halt, and that is that your enterprise managers, instead of thinking of rational economic behavior, become empire builders because they know they are not going to be held responsible for the outcome of their investment decisions.

It is no surprise that Chinese complain that they have runaway domestic investment. So did the Eastern Europeans. And unless they solve that problem, then I think the reform runs a real danger not of being reversed but of just stalling out.

The question of bureaucracy in China—I don't mean all of the usual complaints about it. Bureaucracy exists everywhere, God knows, but there are some particular problems that make bureaucracy more difficult in China.

It takes an awfully long time to do anything and when you read about businessmen complaining about the high cost of doing business in China, a lot of times the press assumes they're talking about—and sometimes they are—the high cost of hotels and all that kind of thing, and that's part of it, but the real cost is the amount of wasted executive time which is very, very expensive. Companies just can't afford to spend a great deal of time doing something that would take half the time in another country.

There is also the problem of bureaucratic fiefdoms. Even though you get economic reform and you get policies that say that certain things will happen, a minister in China who controls not only the government mechanism but also the factories that relate to that ministry can and often does thwart or obstruct those changes and regulations.

The other major area that Nick Lardy referred to is investment and in foreign investment which was doing quite well but dropped about 40 percent this year. At least new commitments dropped about 40 percent. I'm happy to say that I am quite encouraged about what is happening in the investment area. I just came back from leading a delegation of senior American executives to China. We were invited to talk to the Chinese about ways in which to improve the investment climate. And those 22 articles that came out on October 11, are only the tip of the iceberg.

Those are the general principles. This is the way the Chinese do things. They came out with their foreign investment law in 1979 and it wasn't until 1983 that the implementing regulations came out. This time they've come out with their general regulations on October 11, and State Council Gu Mu, who heads their State Council leading group on Foreign Investment, told me that the implementing regulations, 16 sets of them, will be completely by the end of this year and they will be out and in place by the end of the first quarter of 1987. This is a very distinct difference between 1979 and today.

We were briefed on the October regulations and then we talked at great length with the State Council Leading Group about what these implementing regulations should look like. I'm not going to promise that they are going to do all the things that we would like them to do. In fact, they said that they were not going to be able to do all of the things we recommend, but there are some things they are going to do and I think they will result in a substantial change in the investment climate.

Perhaps more interesting than my observation of that is that all members of the delegation reached the same conclusion. They said that many of them had been inclined not to do joint venture opportunities in China and now they were prepared to go pursue them.

So at a minimum, I think in 1987 you're going to see a lot more negotiations in China on investment, a lot more interest on the part of American companies in investment in China. Whether those come to fruition or not will depend on the precise wording of the new regulations coming out.

But I think some of the really ground-breaking changes that we will see is the Chinese Government now says that it recognizes that it cannot expect individual enterprises to be solely responsible for earning their foreign exchange. This is a major change and that's been the big obstacle.

You can't go into China and invest in making telephones or something for the Chinese telecommunications system and then be told you've got to earn all the foreign exchange—not just to repatriate profit, which is not the real issue, but to get the operating funds you need to run your factory. The Chinese are now saying that you're not going to have to do that, that you will be able to—if you are making a product of that kind, an import substitute essentially—sell it at least in part for foreign exchange. They will essentially revive an article that fell into disuse in the joint venture regulations which provided for the local governments and, if necessary, the central government to make foreign exchange available to companies for operating funds or companies which are not able to earn them through exports.

This has already happened. Just since our trip, one company has already been given over $2.5 million in foreign exchange for its operating costs at the official exchange rate.

They recognize the principle that since saving foreign exchange is the functional equivalent of earning it that they will put import substitution investments on the same basis as investments in export products. That is a very important change because the lack of interest in investing in China has largely been that in most cases the kind of products that companies would make in China would not be competitive on the world market, at least not for many years. So if they had to export and earn foreign exchange they weren't interested. But if they can go into China and make products for the Chinese market and be provided with the foreign exchange to do so based on the fact that they're saving foreign exchange, you will see a great deal of interest in investing in China.

So I am quite encouraged that we will see a major turnaround in that area.

The problems on the U.S. side have been pretty well treated. I would just comment briefly on some of them.

The problem of export control, the old perennial, is still with us and, unfortunately, it's going to stay with us or maybe get worse because the greatest opportunities for export to China perhaps in the next 5 to 8 years is going to be in the telecommunications area and we have been very, very slow to reform the Export Control restrictions on the export of telecommunications equipment.

There is clearly a group within the U.S. Government which, in my view, takes a position that is at variance with the announced policy of the United States. They object to some of these sales on the old standby grounds of the national security of the United States. When you pin them down, they come out with things like, "We don't want the Chinese to have a survivable communications system" or "We don't want the Chinese to have a modern intercity communications system" or "We don't want the Chinese to have an improved command and control system."

My answer to that is, "Why not?" I think we need a fundamental policy analysis of what it is we want and what we don't want and what can we realistically do about what we do and don't want.

What is particularly frustrating I think is that we have been told in such definitive terms that there were certain kinds of telecommunications equipment that were in the so-called "red" zone and couldn't be sold to China, that American companies pretty much gave up on it. And then lo and behold, we find that the British have made four big sales in this area in fiberoptics and they did it by going to the White House and asking for a favor and getting it.

So then you end up with the stuff getting sold to the Chinese anyway and then the U.S. Government says, "Well, don't worry. We've now taken that item out of the red zone and put it in the green zone," but the sales have been made and American companies haven't even begun marketing in that area.

In addition to that, of course, we are at a serious competitive disadvantage in terms of the time it takes to get anything through our bureaucracy in the export control area. A lot of promises have been made but it's still difficult.

Nick Lardy talked about export financing. The United States is completely out of that game. And it's not just Japan. We're getting used to having our clock cleaned by the Japanese. But it's really embarrassing when it happens to you with the Europeans, particularly in areas where they have inferior technology.

Last year, for example, thanks to the strengthening of the yen, the Japanese lost considerable market share in telecommunications equipment, but the Europeans picked it up, not the United States. That's a function of both export control and export financing.

Unless you can offer something like 20-year terms at 5 percent or so, you are just not in the market for some of the large telecommunications or infrastructure projects in China and our competitors offer—Germany is offering 30 years at 2 percent with a 10-year grace period. The Japanese offer similar concessionary financing.

In 1981 in some conversations we had with the administration about this, they sympathized and said that other countries shouldn't be doing this and they were going to see to it that it stopped. Well, we're coming up on 1987 and I don't see any indication that that kind of policy of unilateral disarmament in the financing area works.

Now when I've discussed this, I'm often charged with special pleading for American companies. Let me just point out a little understood fact. That is, what we are talking about is American jobs, not the profits of American companies. When a company—I just pick this name out of the air lest my friends at IBM jump all over me—let me say that when IBM looks around at where it's going to source equipment for China, if it decides that—as it probably would—it's going to get better financing in Canada or in Japan, it will source there. So the issue here is not whether IBM makes money or not. The question is whether the American employees of IBM or the Japanese employees of IBM benefit. So this is really, in the case of multinational corporations, not a company matter but a national matter.

I just saw with some amusement the other day that we've been negotiating with Taiwan to open up the market in Taiwan for automobile sales. Taiwan agreed to open it up to exports from the United States but to keep the market closed for exports from Japan. So far, the only American company that has responded is Honda.

Finally, I think there are problems in American industry itself. It would be wrong not to mention those. Americian companies are much too shortsighted. It's partly a function of the way ownership of American companies works, but since investors in American companies are not owners, there's a bias in American companies to short-term results. That's just the wrong approach in a place like China and that's certainly not the approach the Japanese take.

The Japanese are prepared to build a base of their market and to work for a long time before they expect to gain profit and an American company, if it decides to go into China, has to show some results pretty quickly or its stockholders and board of directors begin to get upset.

Finally, I would just say one other general comment on China that worries me. That is, their is a persistent Chinese tendency toward self-reliance. It goes back through history of modern times. There is a facile tendency on the part of some of us to say they have moved away from that and I think in part they have, but still I think the combination of their historical memories of unfortunate experiences at the hands of American and European businesses and there recent ideological emphasis before 1979 essentially on an autarchic approach to development makes it awfully easy for China to give an unwise degree of protection to an inefficient industrial structure.

We have seem some blatant examples of this recently and, in addition to causing political problems, ill-will in bodies like the Congress of the United States and raising fears of unfair competition and so forth, what the Chinese have to understand is this is going to seriously damage their own modernization efforts. This is a very serious long-term problem.

If China persists in shielding inefficient firms from competition—I'm not talking about protection of infant industries which of course they're going to have to do—then their efforts to improve the efficiency of their enterprises is going to be undermined and their own ability to earn foreign exchange will erode.

So I think that, in addition to doing something about export control and beginning to at least address how seriously we're being damaged by the lack of any kind of project financing in China, we should not only applaud the efforts of the World Bank who make the argument forcefully to the Chinese about protectionism in China, but also that as a member of the World Bank we should encourage the Bank to monitor that issue very closely and ensure that in its loans China makes a commitment that they will not revert to excessive protectionism for those industries. Thank you, very much.

[The complete statement of Mr. Sullivan follows:]

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SYMPOSIUM
ON
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JOINT ECONOMIC COMMITTEE
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THE NEW CHINA -- MIRACLE OR MIRAGE?

Roger W. Sullivan
President
National Council for U.S.-China Trade

THE NEW CHINA: MIRACLE OR MIRAGE?

I would like to use my time to make several points. They all involve complex and controversial questions, each one of which would require detailed investigation that is not possible in the space and time available to me. None of these questions is susceptible to easy or definitive answers; what I will try to do is to outline the key questions; provide my assessment of the present situation and provide some documentation which I hope the committee will find useful in its deliberations. My essential themes are as follows:

- China's economy and its foreign trade sector are experiencing difficulties but these are greatly exaggerated in the popular media.

- The greater danger is not that U.S business and government will waste resources in China but that the current climate will prevent us all from properly assessing the long term potential of U.S. commercial relations with China and taking the steps necessary to position ourselves to take advantage of that potential.

- China's leaders are responding in a remarkably pragmatic way to the difficulties that they are facing. Their reactions in the past year as in the previous seven years have been fairly consistent to overcome their obstacle by further economic liberalization.

- It is critically important that the economic reforms process in China not falter and that prompt steps be taken to make China more attractive to foreign investors.

I need not go into any detail about China's general economic performance since 1979. While "miracle" might be too strong a term, certainly the performance has been impressive. I will leave to others to document this point, . . . what I would like to emphasize is that what is most impressive about the performance is the consistency with which Chinese leaders have held to their main policy guidelines since 1979. One hardly needs to add that these policies include dramatic departures from China's previous political policies concerning self-reliance, investment in China, willingness to go into debt and allowing foreign multinationals to jointly (with Chinese organizations) exploit China's natural resources. Such policies must be polit ically controversial in China and one might have expected that Chinese leaders would have substantially drawn back from such policies when faced with major setbacks. Yet the Chinese reaction to problems in their more liberal domestic and foreign policies since 1979 has generally been to take one more step towards increased liberalization. At the beginning of the year there were many who feared that 1986 would be a very poor year for the Chinese economy, China's trade overall and U.S.-

China trade in particular. Actually 1986 has not been a bad year, except for foreign investment which is off by almost 40%.

China's domestic economy has been slowed considerably (the industrial growth rate was 6 % for the first 8 months) but appears to be on target to achieve the planners' goals. A renewed emphasis on grain has apparently turned around the declining output in this key commodity.

This has not been achieved at the expense of the economic reform program. China has continued to experiment aggressively with reforms in capital, labor, and material supplies markets. In most cases the reforms have been marginal and experimental. Nonetheless, there is a surprising degree of willingness to experiment with concepts as far-reaching as stock markets, markets for foreign exchange, allowing enterprises to seek capital from individuals and other enterprises and other schemes to encourage the flow of capital from inefficient sectors to sectors where it can be used more profitably.

The drastic reduction in foreign trade that was feared has not happened. Here again, the growth rate of the previous years has not been sustained -- but who would have expected that it could or should have been? It now appears that Chinese planners were considerably more successful at expanding exports (up by 14.8% in the first 9 months) than they or anyone would have anticipated -- especially in view of the sharp reductions in the price of their main export product -- crude oil and petroleum products.

Nor did the Chinese leaders impose the feared draconian cutbacks on imports which expanded modestly by 5.1% (during the first 9 months).

Why the sudden and precipitate drop in foreign investment? The reasons are not hard to find. I am not referring to concerns about China's economic prospects. The consensus of economic analysts is that they are right. Nor am I referring to concerns about continuity in leadership and policy in China. A second and even the third tier of successor leadership are already on the scene and the policy of opening to the outside world, despite disagreements over pace, enjoys wide support. I am talking about the current investment environment, which in most respects is not competitive with sites elsewhere in East Asia. Unless China becomes more attractive to foreign investors, the loss of both capital and technology transfer will hamper China's modernization efforts and seriously cripple its ability to generate export earnings.

I have just returned from China where I headed a delegation of senior American executives who were invited to China to discuss improvements in the investment climate. We were encouraged and impressed by the openness with which Chinese officials were prepared to talk about the problems and what might be done about them. State Councillor Gu Mu, who heads a newly-created State Council Leading Group on Foreign Investment, briefed us on the new regulations, which were issued in October, and more detailed implementing regulations now in the drafting stage which will be in place by the end of the first quarter of 1987. The objective, he said, is to turn the situation around and to do so quickly. I need not go into the specifics of what the Chinese propose to do. It is sufficient for our purposes today to note that it was the consensus of the executives on the delegation that the investment enironment in China is going to get better and maybe dramatically better in 1987. We'll have to see what they actually do. Vice Premier Yao Yilin cautioned that they might not be able to implement all our suggestions right away, although he conceded that our proposals were all "reasonable".

If China does what it needs to do to achieve its goals of quadrupling foreign trade by the year 2000, what assurances do we have that the United States is going to remain competitive?

The United States is now China's third-ranking trade partner, after Japan and Hong Kong, with about 12% of China's trade. Future prospects look encouraging because the sectors China has designated as high priority are in so many cases precisely those in which American technology and equipment are either preeminent or at least competitive. The list is long and impressive, including oil exploration and exploitation, electrical power generation, rail and airlines modernization, telecommunications and electronics. The obvious complementarity of Chinese plans and American capabilities has prompted some Chinese to predict, and Americans to hope, that over the next decade, the U.S share of China's trade should rise significantly from the 12-13% range of the past five years.

But this represents only what is possible. The reality may prove disappointing if we in the United States are unable to overcome our comparative disadvantages in the areas of export control and project financing.

China's plans for the rest of the 1980's call for exports to grow between 8 and 9%; for imports to grow modestly at around 6-7%. Since the plan period begins with such a very large trade imbalance, it is clear th

Chinese planners anticipate that they will run a continuous trade deficit of about $12 billion annually throughout the plan period, or alternativel a cumulative trade deficit of around 50 to $60 billion.

China will be looking even more intensively to borrow from the World Bank and Bilateral aid and blended financing programs. I cannot stress t strongly that all of my conversations with American business representatives and with Chinese officials invariably pinpoint the lack o competitive financing as one of the key constraints (the other is export controls) on American business. Most of China's major trading partners have assessed the situation and have decided to pursue business in China through aggressive financing packages with which we in the U.S. simply do not compete.

It has already cost us heavily and will continue to do so. Many of our engineering companies and suppliers of capital equipment have told me that to remain competitive in China it is necessary to use their foreign subsidiaries in order to take advantage of foreign financing. The net result, of course, is the loss of U.S. jobs. Our comparative disadvantag will become more pronounced when China begins to spend heavily in telecommunications and major power projects.

I have attached a Table with a detailed listing of many of the programs available to China from other countries. I submit that if you l at it from the Chinese point of view, it makes it very difficult for the to buy U.S. equipment unless there are overwhelming advantages of technology or price. Unfortunately, this is generally not the case.

Even when our technology is superior or at least competitive and financing is not a problem, we are at a comparative disadvantage because of persistent export control problems. Restrictions on high technology sales to China have been significantly liberalized over the past three years. In critical areas, however, improvement is urgently needed. Export restrictions on telecommunications equipment, for example, have cost U.S. industry significant business in China. A high level goverment-business delegation which recently toured PRC telecommunications installations found primarily European and Japanese advanced equipment in the system and hardly any U.S. equipment. U.S. restrictions on fiberoptics technology transfer, an area in which China earlier looked to the U.S., have significantly inhibited U.S. business. It took a recent UK telecommunications sale of single mode fiberoptics equipment, in which the British government prevailed on the White House to override DOD objections, to bring about a change in U.S. restrictions in this sector. The way in which the fiberoptics restrictions have been relaxed have also put U.S. industry, which hitherto has been unable to market its product, in an unfavorable position vis-a-vis our foreign competition. Controls on other sectors such as semiconductor manufacturing equipment and networking also need to be relaxed.

In addition to liberalized guidelines, the U.S. government approval process itself must be improved, for delays in processing export licenses have also cost substantial U.S. sales. A better system for resolving disputes between Commerce and Defense must be developed. Also, a better system of tracking the high technology sales of both U.S. and other foreign nations to the PRC is badly needed.

The final problem that concerns me, and I am sure concerns you as well, is the persistent Chinese tendency towards self-reliance. No one expects China to become a foreign trade-oriented economy. Its massive internal market and centrally-planned economy tend to be biased towards maintaining control over their own production and distribution plans.

Unfortunately, the combination of historical memories of China's unhappy experiences with foreigners and the recent ideological emphasis on self-reliance creates an atmosphere which makes it easy for China's domestic industries to demand an unwise degree of protection for an inefficient industrial structure. In some cases, we have seen some blatant Chinese appeals for protection simply because, according to their own analysis, their firms are uncompetitive.

In addition to causing ill will and raising foreign fears of unfair Chinese domestic protectionism, such policies will damage China's modernization efforts. If China persists in a policy of shielding inefficient firms from competition, China's effort to improve the efficiency of its own enterprises will be undermined and China's ability to earn foreign exchange will erode. We all should applaud the World Bank for forcefully making this argument to the Chinese. I believe that as a member of the World Bank, the U.S. should encourage the Bank to continue to monitor this issue closely and ensure that in its loans to China, the Chinese make a commitment that they not revert to excessive protectionism for those enterprises.

Finally, we should use whatever leverage we have in our own Bilateral Investment Treaty negotiations with China as well as in developing our position on China's application to the GATT to ensure that China's market remains open.

Mr. ROMBERG. Thank you, very much. Let me say that I'm going to try to group questions as much as possible. We've got only between 10 and 15 minutes left and so I will perhaps not read all of the questions I've gotten in recognizable form but I will try to group them.

I think that the panel has provided implicitly at least two questions for Chairman Obey regarding the prospects for United States aid for China—since Nick Lardy suggested that we're at a disadvantage at least behind Japan because of that, although I don't know if he's advocating an aid program—and also the question that Allen Whiting raised about fellowships.

Whether he chooses to address that or not, I know that Chairman Obey has a question he would like to begin this part of the session with.

Representative OBEY. I didn't expect to be asked a question. That's not within the rules.

Mr. ROMBERG. Sorry.

Representative OBEY. I will respond briefly before I ask a question.

In terms of any aid that might be provided, I really frankly don't see that for quite a while, at least under existing circumstances. Policy questions aside, the problem with the present budget situation is that—wearing my other hat as chairman of the Subcommittee on Foreign Operations of the Appropriations Committee, which in plain language provides foreign aid, Gramm-Rudman and our present budget deficit crunch have simply leeched out of the process our ability to deal with substance.

All we are dealing with at this moment is the question of whether or not we can fit $15 or $16 billion worth of requirements into an $11 or $12 billion bag because of the budget crunch.

We had to—not because we enjoyed it from a policy standpoint but because we had no choice fiscally last year, we had to reduce substantially the administration's foreign assistance request and that will certainly happen again to a much greater degree this year than it did last year. I don't say that with relish. I say that simply because I can't repeal the laws of mathematics, I have to work under them.

In terms of fellowships or in general our support for those kind of programs, all I can say is what I said yesterday. I would not be here were it not for Sputnik which generated the U.S. effort under the National Defense Education Act to create area studies programs around the country, one of which I participated in, in the Soviet area study.

Paul Simon and a number of others have pushed especially to focus efforts on language. But again, we are being squeezed on all fronts because of the reluctance to face up to the fact that you cannot double your military spending over a given period and cut your revenue base at the same time while you are not reducing your expenditures commensurate with those changes.

I don't know of—on the Republican or Democratic side of the aisle—any serious collection of people that think that we can meet Gramm-Rudman targets this year simply by spending reductions. That means that we are stuck with a revenue requirement and if we can't get it through, we're going to see a lot of things not just restrained but savaged.

I think that Jim Wright has tried to make it quite clear that he doesn't want to let that happen. I don't know what will happen in the process.

Let me simply ask the question I wanted to. If we want to extend it a few minutes past 11:30 then let's do that, unless you've got a problem.

My question would be this. What kind of people are there in economics ministries making decisions and staffing the decisionmakers in China? What's being taught in Chinese universities today about economics and economic problems? What is the picture, if anybody knows, about where chinese students are studying abroad, what are they studying abroad? What implications does that have for us in terms of policy directions that they are likely to be following 15 and 20 years from now in the economics arena?

Mr. **Romberg**. Nick, do you want to try that?

Mr. **Lardy**. Perhaps I can comment on the second part of the question and then you might ask Roger to comment on the decisionmaking in the ministries.

The progress that's being made in this area is significant but I would still say relatively gradual in terms of teaching modern economics in Chinese universities. They are beginning from a base in which what is taught in economics departments is primarily political economy, which means Marxism. And a few universities are moving away from this, primarily with the help of World Bank lending in the educational area which is being directed in very significant proportion into economics and through a relatively small program funded by a number of private U.S. foundations under the leadership of the Ford Foundation.

But the numbers of people that are being reached in these programs is still extremely small. The Ford program, for example, has some training programs run during the year at a couple of major universities that bring people in from all over the country and attempt to teach them modern economic methods.

In addition to these efforts, there are some national centers for training in management, the Dalian Institute that the U.S. Government is involved in; and a number of other countries, the Canadians, the Germans, and so forth also have management institutes that are training people.

I think the question that hasn't really been answered yet is, how effectively people trained in these various programs are being utilized? I think that's something that will only emerge over time.

My own sense is part of what Roger was talking about, the bureaucracy, that still most of the investment decisions seem to be made largely on political criteria rather than economic criteria. That's why there is a long delay and debate about many major projects. Decisions are reversed and then put in place again.

I think this largely reflects the primacy of politics in lots of investment choices, import choices, project choices, and so forth. I think that's likely to erode only very slowly.

Mr. **Whiting**. Let me speak about two groups that I dealt with this summer. In the Ministry of Foreign Trade and Government agencies I found the economists very factual, objective, and self-aware in terms of how does one get a trade balance with Japan, how does one get increased Japanese investment in long-term projects. No political illusions are here at all but a fine sense of what the situation is like. They admit it is a difficult situation for China which will remain difficult for a number of years.

In the academic and private sector, outside of government, economists' writings have virtually no dogma and no Marxism/Leninism about Japan. I read one book on how Japan rose from the ashes of 1945 to the present. This long study extracted seven lessons for China's potential economic development. It could be translated into English and be well received in this country.

Mr. SULLIVAN. Could I comment on that, too? When I was there just last month I had some extensive meetings with the State Economic Commission as well as the Ministry of Foreign Economic Relations and Trade and with the State Council Trading Group on Foreign Investment and I was struck by a couple of things.

One is that their economists are either in their sixties or older or in their twenties and there is a big gap in the middle, but I was very pleased to see that not only are they retreading some of the people who were perhaps in trouble before but they are letting these very young people participate actively.

At the meeting with the State Economic Commission, for example, a woman who looked to me to be 25—it's hard to tell, she may be a little older than that—was the one who gave us the briefing on the treatment of import substitution industries. With great authority and considerable expertise and with no ideological content at all she gave us a very good briefing not only on how they saw the problems but what they thought should be done about them.

At the end of the meeting, when I mentioned this to one of the senior Chinese officials, he smiled and said, "Well, that's interesting." He said that somebody asked him one time what the major difference was between now and a few years ago. He thought about it for a while and he finally decided that at all the various meetings that he went to on economic matters how people might raise objections to something as being impractical or not politically doable, but nobody in his recollection in the last 2 years had ever raised an objection to a proposal on the grounds that it was contrary to Marxism or Leninism.

Mr. RINES. I guess I would echo very briefly that the people I have met in the financial area—and to be sure it's a very small group of Chinese—I have found them to be up to speed comparable to financial people in Europe as they have to be. They're very intelligent, very capable, and very knowledgeable about the capital markets.

Mr. ROMBERG. Let me try to group a bunch of questions on the issue of the domestic economy. I suppose one set of questions is—and perhaps Nick Lardy would be the one to address these—how confident are we about not only judgments about productivity and what figures we use there, but even about basic production data? Are there still problems there that historically have been with data?

If I may just piggyback on that, what kind of industrial reforms do you think are going to be necessary to promote the level of industrial growth, perhaps not of recent years which as Roger Sullivan pointed out may have been too high, but which will generate the kind of growth in trade and dynamism which will keep China moving forward and meet the various trade objectives that they have and which we are discussing today?

Mr. LARDY. Let me begin with a few comments on the question of the data base on which we understand and interpret the Chinese economy.

In terms of production data, the Chinese data are as good or probably better than most developing countries. We really have no trouble tracing patterns of development in various sections by various commodity categories and we even now have reasonably good data on China's national income, although they calculate it on a slightly different basis from Western practices.

When you go into some specific areas there still are problems. In the trade sector, they release data that is from various sources in China that is not necessarily always consistent and certainly very difficult to interpret the data that come out of the Statistical Bureau versus the Customs Administration and various things like that.

The data on capital flows and nonmerchandise trade elements in the balance of payments is, I would say, the most problemmatic area. The data the Chinese have been releasing on, for example, the amount of direct foreign investment that they have been utilizing varies from different sources by a factor as much as two when they appear to be using the same underlying concept; that is, capital actually used as opposed to commitments.

So, there are a lot of problems in all of the nonmerchandise items in the balance of payments; that is, services, remittances, direct foreign investment, borrowings, and so forth. I think we don't know. Maybe Roger has some numbers, but I don't think anybody really knows—and I've heard people who have looked into this say there's probably no one in China who knows how much the Chinese have borrowed now on the international markets. Some people hypothesize there's been somewhat of a loss of control in terms of their borrowing on international markets.

Lots of Chinese subsidiaries abroad or in Hong Kong, for example, are borrowing large amounts. It's not clear that all these borrowings are reflected in the official data on what the Chinese have actually borrowed. This is commercial borrowings I'm speaking of now.

In the area of industrial reforms, I would just comment very briefly. I think the major obstacle has already been alluded to. I mentioned earlier and Roger has touched on it and I'll just say a couple more words.

I would say that there really is a need for basic reform of the raw material prices which still tend to be relatively undervalued in China. Energy is the most obvious, but there are a number of others.

There needs to be a reform of some of the over-priced products that are sold on the market primarily to generate tax revenues and, of course, this process hinges on a fairly substantial change in their tax structure. Basically, they don't have a tax structure and rely on profits of government enterprises. So, the variation and the degree of profitability across industries is enormous in China, far greater than it is in any other centrally planned economy.

So, they need to have a price reform. That relates to the question of bankruptcy that Roger was talking about earlier. You can't force enterprises to go bankrupt when many of them are losing money because their products are underpriced according to official regulations. So, that goes hand in hand with engendering a more competitive industrial sector. You have to have price reform first. Then you can have a bankruptcy law. I think this is the reason the National People's Congress took the unprecedented action a couple of months ago and turned down the bankruptcy law, refused to approve it, a rather remarkable development for an entity that is thought of as a rubber stamp body.

China needs more competition in the industrial sector, not only internationally, which Roger has referred to, but also domestically as well. There's a great deal of local protectionism, lots of small inefficient plants being cultivated by local political leaders because they generate revenues and so forth for local governments. Indeed, I think that's one of the fundamental problems of this current reform and that is that it puts far too much power in the hands of local government.

They talk about decentralization in China and what this means is local governments have all kinds of incentives under the current arrangements to cultivate small inefficient production. They don't allow goods from other provinces to come into their area.

So we are not going to see, in my judgment, a dynamic industrial sector domestically until we have some further progress on the price front, some greater introduction of competition both domestically and internationally, and a very substantial curtailment of the powers of provincial and other local governments to control the enterprises that exist within their regions.

The real key, in other words, is the independence and the autonomy of the enterprises within the overall system.

Finally, I should mention that one of the major problems that Roger has already alluded to is the continued underpricing of capital in China which creates an excessive demand and overheating of the economy and very high rates of investment. That's one of the reasons that productivity has declined in the industrial sector since 1978.

There is an enormous excess demand for capital because capital, if you can get your hands on it, is by and large still a free good. So there needs to be reform in that area as well.

Mr. **Romberg**. I'm not going to try to go down the whole panel unless somebody has some specific things to say. I would just add that I think this whole question of price reform and of the "need to fail," the bankruptcy law and so on, these are absolutely crucial fundamental questions. I'm not sure of the answer of whether they are going to be able to do that.

Mr. **Rines**. Could I amend possibly an erroneous impression that I gave in regard to my position on the bankruptcy law. I certainly do believe it's vital. My example about only one business failure occurring thus far was only to suggest one of the reasons why the need for the law hadn't gotten much prominence in earlier years.

Mr. ROMBERG. Let me turn if I may to a set of questions on the issue of China's foreign trade policy and general foreign policy.

A part of that would be, how much does China integrate its foreign trade policy into its general foreign policy? A second part of that would be, how much does it really matter to the United States, either from an economic or a political point of view, whether Japan is and continues to be China's No. 1 trading partner? Going back to the question which was raised in a couple of the comments during presentations, does it matter very much from a political point of view what is happening in Sino-Soviet trade, and indeed, aren't there real limits on Sino-Soviet trade such as the fact that they really do depend very much on barter rather than using foreign exchange, at least for other than their clearing account, and what implications does all of that have for China's trade policy and for U.S. interests?

I'll throw one final thing into that question and then see who wants to tackle all of this. As one questioner puts it, one of yesterday's panelists characterized the U.S.-NIC relationship as one marked by basic economic complementarity. How would you characterize the economic relationship between the NIC's and the P.R.C., as one of complementarity, as one of competition and conflict, and what are the implications of that set of relationships between the P.R.C. and the newly industrializing countries in Asia to the United States?

Who would like to try that?

Mr. SULLIVAN. Let me start and make a few general observations.

First of all, I think I don't really know what China's foreign trade policy is and I'm not sure they do. I think that they are still torn between using trade as an engine of growth or simply using trade as a way of gaining access to technology and going back to self-sufficiency.

I think, as in other countries, political questions like that are probably best not debated and people just sort of cope and go along. But I think that's a major question that the Chinese are going to have to begin to answer because it goes to the question of what you're going to do with the foreign investors and all the rest of it.

Let me say a few things about the competition that we have. I really cannot take the Soviet trade threat seriously. I have been informed pretty reliably I think—I'd better not quote my source because I'm not sure I should—by a senior Chinese official, that the Sino-Soviet is a $10 billion agreement over 5 years and that comes out to $2 billion a year. Since we are already at $8 billion a year and growing, it seems to me at the end of 5 years United States-China trade is still going to be 10 times the Sino-Soviet trade.

I also can't take it seriously because, as Alan said, it's barter and when you look at what the Chinese are looking for, the Soviet Union just isn't in the game. The high priority areas in China are all in areas where we are either preeminent or at lest competitive and that's a very long and impressive list—in oil exploration and exploitation and electrical power generation and in rail and airline modernization—I can't believe that the Chinese are going to switch back from Boeing to Ilyushns—telecommunications and electronics.

In fact, the list is so good from the standpoint of our competitiveness that if it weren't for the other disadvantages in export financing and export control that I mentioned, our share of China's trade should be rising significantly from the 12 to 13 percent level it's hovered at for the last few years.

I am not even so concerned about the Japanese competition. It's interesting that last year Japan's export to China declined by almost 25 percent and that is partly the Chinese telling them not just that they don't like some of the behavior patterns of the Japanese, but they don't particularly want to become a feeder economy to the Japanese economy. I think the Chinese have a serious issue here. They point out that they don't want to be a country that simply supplies raw materials to Japan and takes back manufactured goods. And they have the same complaint against Japan that everybody else has, that the Japanese won't buy any of their manufactured goods, have quotas against them, have high tariffs against them, and outright prohibitions against some of their products.

So I agree that Japan will probably remain the major trading partner of China but I don't think their share is going to increase a great deal because the Chinese are going to try to prevent that from happening. So 22 to 24 percent is probably where they will hover.

What worries me is that, because of our lack of ability to compete in the technology transfer and capital transfer area, we are going to lose ground to the Europeans who have been out of it pretty much up to now. We are already seeing signs of that.

As I mentioned we see more and more examples of where the Japanese lose market share and that market share is picked up by the Germans or the French.

The only bright note I guess is in computers and electric office machinery where last year the American market share in China went from 35 to 53 percent. So at least we're shining somewhere, but that's an area that doesn't depend on export financing and now doesn't depend on export control because the export control problems in that area have been pretty well resolved.

Mr. **Romberg**. Allen, do you want to take that?

Mr. **Whiting**. Well, I think that there are times when the Chinese have integrated foreign policy and foreign trade, buying more expensive goods from a country where they wanted to show political favor, cutting imports where they wanted to show political disfavor. At times we have benefited from this in our grain trade and at times we've suffered from this in our grain trade.

So these are at times connected, but basically I would agree with Roger that the foreign trade program is not linked to the foreign policy program and the foreign trade program as a program may not even be a coherent whole.

Mr. **Lardy**. Let me just make a general comment. I think that the foreign trade policy is much more complicated in China than it was a few years ago. A decade ago the Ministry of Foreign Trade was in complete control through its foreign trade corporations.

Today, you have a much more complex, variegated scene where you have a large number of actors which are becoming quite important. Roger and I could rattle off dozens of commissions and various other entities at the national and provincial level where there are all kinds of direct relations and activities with foreign firms. And the role of the Foreign Trade Ministry, now called the Ministry of Foreign Economic Relations and Trade, is certainly very substantially diminished as compared to only a few years ago and I think that's part of the increasing complexity of the business environment there and I don't think that that's something that's going to go away. You have a much more diverse set of policy actors.

On the question of Sino-Soviet trade, if I could just say a word on that, I think that I do agree with Roger that we do have comparative advantages. Certainly in high technology areas the Soviets are not going to be able to satisfy them. But I think we have to recognize two things. The Chinese do import lots of industrial products that are not particularly sophisticated in terms of their level of technology—lots of steel, all kinds of manufactured goods, electric power generating equipment, and so forth—that the Soviets are supplying.

The Soviets are supplying very large quantities of jet aircraft to China. Over the last year or two, they have purchased about 20 Tu-154's which is a medium-range, tri-jet aircraft that's being used extensively in China. They are buying also from the Soviet Union a substantial amount of raw materials—timber and so forth—and that rate is likely to grow very significantly in the years ahead and I think that's a trade that comes at the expense to a great degree of the United States.

On the other hand, you have to recognize that because of protectionism in the United States and some other quarters, as well, the Chinese are finding a very substantial market for their products in the Soviet Union. One of the most rapidly growing items is obviously textiles. In 1985, for example, their textile trade with the Soviet Union went up something like $600 million, which allowed them to almost completely offset the curtailment that was imposed on them in their textile exports with the West.

So the Soviets are a market for many products that they can't sell so easily in the West. The Soviets can supply them with many goods that are competitive with goods coming from the West and the fact that the trade is barter in the current environment where the Chinese have had difficulty expanding their exports into the world market I think, at least in the short run, is going to work to the advantage of increased Sino-Soviet trade. So I think I would turn it around in that respect.

Mr. SULLIVAN. Let me just make a quick comment. Just because the United States talks about restricting textile imports from China doesn't mean we do it. And I have the figures here from 1986. It's very interesting. You said that they sold $600 million worth of textiles to the Soviet Union.

Mr. LARDY. Increased.

Mr. SULLIVAN. OK. The increase in our imports of Chinese textiles 1986 over 1985 is $700 million, up to $1.382 billion, and the reason is that protectionism doesn't work. Protectionism keeps the Chinese from selling in certain restricted areas, and what the Chinese do is what countries in Asia have been doing for the last 30 years: they shift to categories that are not protected. Even in the areas that are protected, they go up scale because the restrictions are on square yardage not on dollar value, and there is room for mammoth increases in that even aside from any changes in restrictions on the U.S. side. The reason is the Chinese are already able to sell almost $1.5 billion worth of textiles and apparel to the United States even though they can't compete in high style clothing because their delivery schedules and their quality control are not good enough. There is plenty of room for improvement on that side if, instead of focusing on so-called protectionism in the United States which obviously doesn't exist, the Chinese would focus on things like improving quality and delivery times. They could do very well indeed.

Mr. ROMBERG. Let me ask one final question. Chairman Obey said I should ask a brief question. I have a big question but I'll ask for brief answers.

There obviously is some range of opinion on this panel on the question which Mr. Obey raised at the beginning but has been touched on I think by every panelist, and that is the durability of this economic policy or economic reform and everything that goes along with it.

I'm not asking you whether you think the policy is durable because you've addressed that. The question would be, what are the implications for the United States if in fact the various obstacles which have been talked about, either natural obstacles or bureaucratic obstacles or market problems in the West, prove to be real problems for China and, indeed, sets back China's growth and development substantially?

That's a very large question but let me ask you really to keep your answers short. Why don't we start at that end of the panel and just work our way back up.

Mr. SULLIVAN. I was just getting used to the idea that our hostage policy was unshakeable, so I don't know about change in China's policies.

I find a question like this very hard to answer. It's easy to say that things can go wrong but you cannot operate on the basis that they might. You really have to operate of the basis that things will go more or less in the direction there're going in and take what actions you can to position yourself to benefit by them.

I am much less concerned—and I think in talking to companies making investment decisions or business decisions in China they feel the same way—much less concerned about a dramatic change in policy in China or a reversal of the post-cultural revolution policies or even a reversal of economic reform. I think you see that in the willingness of companies to enter into long-term, 20-year and more, agreements in China.

I think the concern is really much more a fine-turned concern. The concern is over questions of timing and over questions of our relative competitive position. But even there, there are limits.

I think that we can argue and worry about whether we're going to increase our share of China's trade from the 12 or 13 percent up to 16 or 18 percent, which I think is very feasible, or whether we're going to drop down to 10 percent, but I think that's probably the range in which we're talking.

We can talk about whether China's economic development is going to be in the 8 percent a year or in the 7.5 percent per year, but it's almost in that kind of a fine range that you get argument. In their export trade policy I think you can get argument over how they are going to ride through their short-term problem. The Chinese clearly cannot generate rapid increases in their export earnings and you can get discussion as to how they can and should or will deal with that short-term problem. But most people I talk to, at least, agree that over the longer term they are not going to have a great problem generating sufficient export earnings to support what their objectives are in economic development.

One reason why I'm more encouraged now than I was a year ago is that based on our past experience you would have throught that the Chinese way of working their way out of this short-term difficulty would have been to hunker down and cut sharply back on imports. That, in my view, would have been a disaster. It would have affected dramatically their economic development plans and, of course, it would have affected trade for all of us.

They didn't do that and that's why I say one of the most important things that's happended this year—and it's not been sufficiently noted—is that the Chinese have broken that link between imports and exports. They are willing to run deficits as a matter of national policy—they're planning to run dificits for the next 5 years—so I think that we have reason to be optimistic that within those tolerances I mentioned that we will see China's economy essentially meet the goals they have set. Their foreign trade goals I think will be met and my bigger concern is whether we're going to participate in that.

Mr. **Romberg**. Thank you. Let me ask for brief answers from the other panelists.

Mr. **Rines**. I guess I would say that I would agree with Roger that the emphasis is not, rightly or wrongly, on whether or not these changes will continue or whether or not they will be reversed. I happen to think that they won't be reversed. But really it's how to deal with the problems on a day-to-day basis, how to make a profit, how to cope with the inevitable changes that go on.

In terms of the implications for the United States, I think from a marcoeconomic standpoint at this point they are not major if Chines policies happen to turn around, but it's too big a question to really answer in the time available.

Mr. **Whiting**. I think the Japanese and the Chinese formed what they call the Commission for Sino-Japanese Friendship in the 21st century, recognizing it may take them that long to have friendship, but they are both at the official level determined to keep that target on focus and manage as best they can the provocation and problems that arise in that relationship.

And I think that is the kind of over-the-horizon dimension that we have to have if we're going to do business in China but that it will be a long upward thrust with interruptions, without speed, but it will have the kind of payoff to make it worth it.

Mr. **Lardy**. Well, I think I basically agree with Allen. I would say that one has to always keep in mind that reform is a process and I think the process is going to continue. Too frequently we reduce our discussion to thinking of reform as a condition or a state of affairs or result. I think the magnitude of the task that they are undertaking in reform is enormous, one that we sometimes underestimate, and I think that the real issue is not whether or not there will be reversal—I don't see reversal in the cards—I think the issue is the pace of reform and its success and I think we have a very major stake in the success of the reform and I think our policy should be geared with that in mind, but I think one has to take a long-term view and not expect a continuation of trends necessarily of recent years.

Mr. ROMBERG. Thank your very much.

Representative OBEY. Well, thank you all. Let me simply say that over the last 2 days I think we have had some excellent analyses of the history of the economic relationships of the United States with the countries in the region under discussion. We have had an exploration of today's problems and some educated judgments about what tomorrow holds. We have looked at nations of the Pacific Rim both as competitors and as markets and potential markets for U.S. products and services.

The subject is important because it has implications for the stability and the health of the world political order and the world economic order and our position in both of them.

There are important choices that have to be made on the other side of the Pacific as well as on our own and we can indirectly affect those changes to some degree on the other side of the ocean. One would hope that we can directly and expeditiously affect the policies for the better that need to be changed for the better if we're going to do what this session has been all about, which is to try to find ways to help maximize opportunity for an entire generation of Americans. That's really what we're talking about.

I think this panel has made an excellent contribution to that. I very much appreciate the participation of all the members and most especially the participation and assistance of the moderator for today, Al Romberg.

Thank you again very much. Thank you all for coming. [Applause.]

[Whereupon, at 11:55 a.m., the committee adjourned, subject to the call of the Chair.]

APPENDIX

ECONOMIC CHANGES IN THE ASIAN PACIFIC RIM

POLICY PROSPECTUS

Economics Division
Foreign Affairs and National Defense Division
Office of Senior Specialists

CONGRESSIONAL RESEARCH SERVICE

Submitted to

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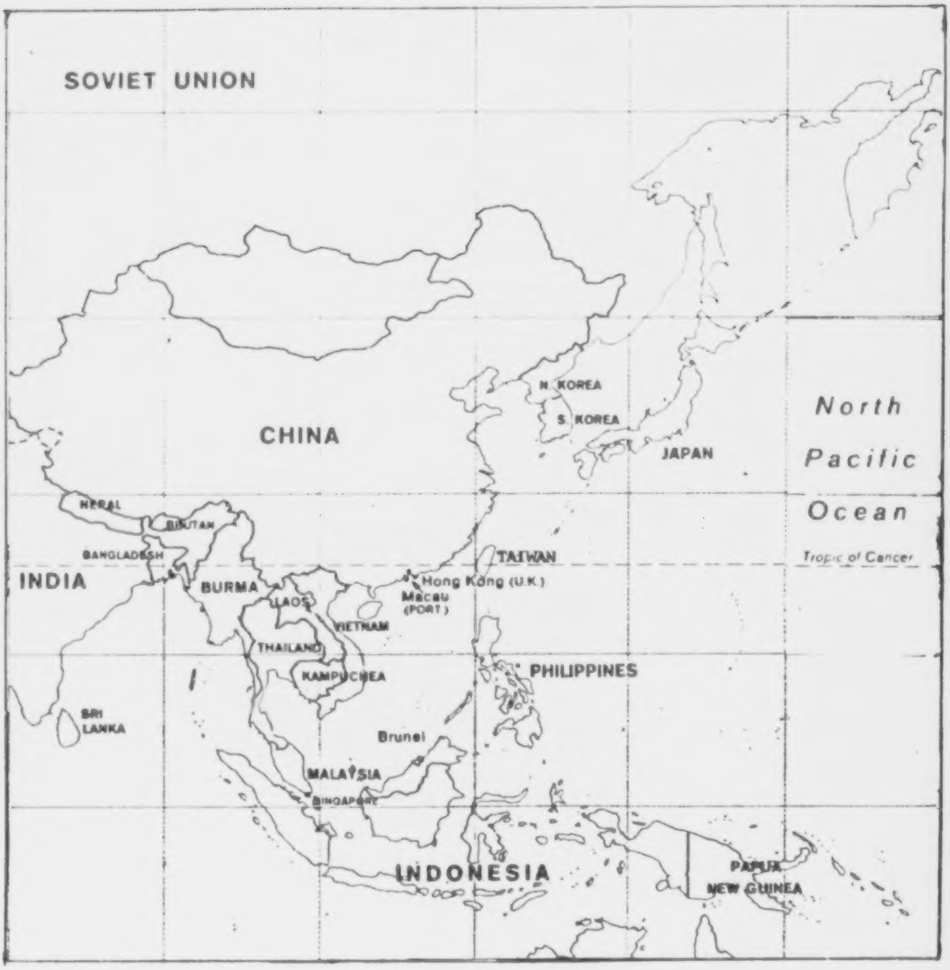
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POLICY PROSPECTUS: DO ECONOMIC CHANGES IN THE ASIAN PACIFIC RIM POSE AN OPPORTUNITY OR THREAT FOR UNITED STATES INTERESTS? *

While United States global trade patterns have increasingly tilted toward the Pacific, the economic and commercial policies of the United States have not kept pace. No fully integrative analyses have been undertaken that take into account the implications of the dynamic Asian Pacific economic development for United States interests. Such a comprehensive assessment of the Asian Pacific economies could serve as a basis for development of clear and realistic policy options toward opening and equitably integrating these nations' economies into the world trading system and adopting policies more supportive of the long-term economic interests of the United States. Such policy options would best be based on a synthesis and assessment both of the past and of the likely economic futures for the Asian Pacific region as a whole and its key individual countries.

To help address these concerns and policy requirements, we have developed a prospectus for a Joint Economic Committee Symposium to focus on the potential economic development of the East Asian Pacific Rim over the next decade in the perspective of the four decades, 1960-2000. The Symposium topics would include the implications of long-term changes in the region for balanced commercial relations between the United States and the Asian Pacific economies, the potential role of Japan and the People's Republic of China (PRC) as economic models for the developed and developing economies of the region, and the relevant policy options for the United States. These assessments would be useful for relating policy options to estimated trends in the Pacific region to the year 2000.

Historical Perspective

Since the Joint Economic Committee began its periodic assessments of Asian economies in the 1960s, two especially significant changes have occurred: Japan and the newly industrializing countries [NICs] have developed substantial trade surpluses with the United States, and the People's Republic of China has been more successful in fulfilling its economic modernization plans than anticipated. The potential impact of these twin Asian events has caused attention to focus on the Asian Pacific Rim as the region of greatest opportunity and threat to the economic well-being of the United States. While there has been intermittent interest in assessing the East Asian Pacific economies over the past decade, the rise of trade deficits and concomitant loss of American jobs and production have given that interest new intensity, and have led to sharp debate over trade policy. Some in the United States perceive a need for more restrictive trade legislation and policy toward the Asian countries parallel to similar policy trends in Western Europe; others contend that a restrictive policy would worsen the U.S. trading position, but argue for more aggressive trade negotiation to assure equitable market conditions.

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* Prepared by John P. Hardt, Associate Director for Research Coordination and Jean F. Boone, Senior Research Assistant, Office of Senior Specialists, Congressional Research Service.

The current confluence of economic opportunities and threats to the economy of the United States and to the world economy may be better understood and assessed if viewed in historical perspective. Over the period of the last two and a half decades, the patterns of economic development in East Asia have varied. The East Asian countries may be grouped into four categories of economic attainment with Japan enjoying the highest ranking, followed by the East Asian NICs, with ASEAN countries generally in a third tier, and China thus far the lowest, especially as measured by per capita income. In terms of total output, Japan has become the super power of the region and the aggregate growth leader of the world. There has been a remarkable change as well in the relative standing of Asian Pacific countries in global GNP and world market shares. Clearly, from a modest level in the 1960s, this region has become a preeminent base of economic power, with the potential of being either the locomotive or the anchor for the world economy. The following are major development processes that have occurred in the region since the early 1960s:

1) Emergence of Japan as a world economic superpower.

2) The dynamic growth of the East Asian Newly Industrializing Countries (NICs): Hong Kong, Singapore, South Korea, and Taiwan.

3) Development within the Association of Southeast Asian Nations (ASEAN), particularly Indonesia, Malaysia, the Philippines, and Thailand.

4) The initiation of the Four Modernizations and Economic Openness Policy in the People's Republic of China.

Time for Asian Pacific Reappraisal of Growth and Trade Strategies

In the Asian Pacific region, Japan led the way in the rise from industrial backwardness to international economic power. The economic strategy of export priority, based on domestic consensus, single-minded export stimulation and availability of foreign markets (especially that of the U.S.) has been eminently successful. Success, however, has eroded the initial assumptions underpinning the Japanese "economic miracle" and a time of necessary reappraisal may be at hand. Japan's remarkable performance and major impact on other countries through creation of trade deficits and market penetration have heightened the foreign demands for a Japanese reappraisal of its growth model. Two negative factors of the model that relate to the interests of the United States are the high degree of United States market penetration apparently necessary for Japanese growth, and the lack of effective American and developing country access to the relatively closed Japanese market.

The NICs have adopted their own versions of the Japanese export-driven growth model, carving their own niches in the export market and developing export-oriented domestic policies. With less negative impact on the world trading community, less success to date than Japan, and different domestic imperatives, the NICS do not seem to be as close as Japan to an urgent time of reappraisal, although it may be appropriate for them as well to review the implications of their growth strategy and consider potential adjustments. Unlike Japan, whose more mature economic strength may allow it to resist world pressures for a change in growth strategy, the NICs may have to adjust to survive.

Hong Kong, Singapore, Indonesia and the Phillipines have long pursued export oriented growth policies, originally tied to the respective colonial powers during the periods of colonial rule. Now the ASEAN countries may find the Japanese formula attractive but their adoption of additional features of the Japanese export-driven growth model could be untimely in the currently imbalanced commercial environment.

Chinese economic achievements, significant by socialist economy standards, provide potential lessons to developing countries in both the communist and non-communist worlds in terms of rural, urban, science and technology, and military modernization. The relative openness of the socialist economy of China offers a formula for bridging the differences between the communist planned economies and the market economies of the West. China's success in generating increased food production and rural industrial output and its apparent management of the balance of food and population growth, so threatening to many LDCs, makes the PRC model especially relevant for the developing economies of the region and the world market. The PRC's unique combination of modernization and openness makes the Chinese economy a potentially burgeoning market for the Western industrialized economies, and thus, China's success will be of particular interest to the United States and the rest of the economically developed West.

The reliance of the Asian Pacific countries on export-led growth has given rise to particular concern since it has helped them to gain increasingly large market shares in the United States for some labor and capital-intensive products traditionally produced in the United States. This trade crisis in the United States and other developed economies not only threatens sectors key to the foreign markets but domestic economic health as well. Thus, Asian Pacific export strategies are seen by some as a threat to the domestic economic development of many industrially developed economies as well as to their shares in the world market.

Although the image of Asian Pacific penetration of the American market is generally negative, the burgeoning markets of the Pacific Rim may at the same time serve as a positive attraction to many. The Asian Pacific region has developed more rapidly than even many optimistic Asian leaders had predicted and its foreign trade and exchanges, involving technology transfers and foreign investment, may grow even faster in many cases than the region's rapidly expanding domestic economies. As a result, one may see considerable opportunity for increased sales, investment and mutually advantageous economic exchanges within the Pacific region. While Asian Pacific leaders promise the United States a rapidly growing market for its exports to the year 2000, American traders fear that a continuing U.S. trade deficit with Asian Pacific Rim countries will be a burden on American employment, production and price stability.

To assess clearly whether Asian Pacific developments are more likely to threaten or to provide economic opportunities for the United States, for other Pacific Rim nations, or for the world economy, a careful analysis is required of the following factors against the historical record:

- the countries' goals of economic development over the next decade;
- the likelihood that Asian Pacific countries will meet or exceed those goals;
- the comparability of those outcomes with the objectives of the other developing and developed nations, and particularly with the interests of the United States.

Comprehensive assessment of the range of outcomes for Asian Pacific economic growth should include, as indicated in the chapters below, consideration of the assumptions and key variables which influence GNP, trade, and measures of economic competitiveness. Prospects for labor productivity, capital efficiency, marketing, direct investment, and other factors influencing competitiveness are considered especially useful focii of attention. Furthermore, it is deemed useful to assess such institutional factors as rates of savings, incentives, and government-private sector partnership in production and marketing, all factors that influence comparative productivity and market competition. The Joint Economic Committee Symposium could serve to initiate a process of synthesis and assessment of these quantitative projections as a useful starting point for broader political-military-economic insights. 1/

Alternative Outcomes and Their Implications for the United States Reappraisal

Based on past performance, decision makers in the United States should now take Asian Pacific projections and economic growth prospects more seriously than in the past. As the United States, in many respects, is the key partner for Asian Pacific countries, we provide many of the necessary economic growth ingredients, including a major market, assurances of political stability, and security guarantees for the region.

1/ Cf. U.S. Congress. Joint Economic Committee. Pacific Region Interdependencies. Joint Committee Print, 97th Congress, 1st session. Washington, U.S. Government Printing Office, 1981; Japan's Economy and Trade with the United States. Joint Committee Print, 99th Congress, 1st session. Washington, U.S. Government Printing Office, 1986; and China's Economy Looks to the Year 2000, Volumes I and II. Joint Committee Print. 99th Congress, 2nd session. Washington, U.S. Government Printing Office, 1986. See also U.S. Congress. House. Committee on Ways and Means. Report on Trade Mission to the Far East. Committee Print, 99th Congress, 1st session. Washington, U.S. Government Printing Office, 1986; Asia Pacific Report: Trends, Issues, Challenges. Honolulu, East-West Center, 1986; U.S. Dept. of Commerce. United States Trade: Performance in 1984 and Outlook. Washington, U.S. Government Printing Office, 1985. Earle, M. Mark, Jr., ed. Pacific Basin Economic Commission (PBEC) Papers. SRI International. passim. 1984-1986.

Most predictions of the economic future of the region illustrate the likelihood of growing interdependence among the economies and societies of the Asian Pacific growing and extending to the entire Pacific region and world market. Although Japan has emerged over the past generation as an economic superpower in its own right, and a powerful "engine" capable of promoting economic development elsewhere in the Asian Pacific area, Japanese progress is likely to be most effective if it complements rather than precludes a continuing strong United States role in the area. In particular, the United States will likely remain a crucial market for Asian Pacific countries seeking to sell their manufactured goods; a significant source of technology, financing and investment; and a center of education essential to the training of future Asian managers and scientists. The United States Government will likely remain a leading force in international financial organizations and will exert major influence on the policies and programs of multinational corporations so important to healthy regional development. Meanwhile, the American security presence in the region would almost certainly continue to provide a vital underpinning to the peace and prosperity of the Asian Pacific countries.

An assessment of future implications for United States interests requires an analysis of the several potential developments that could jeopardize stability and economic development in Asia. The countries of the Asian Pacific region, including the United States, could mishandle their interdependent economic development by seeking their own parochial interests at the expense of others. Thus, increasingly strong developing countries may continue to seek to protect their markets from foreign competition, while exploiting others' markets unfairly. This, in turn, could prompt retaliatory measures, including the introduction of trade restrictions that would jeopardize the trading environment so important to regional progress.

Militantly nationalist tendencies could take a different form, jeopardizing future regional stability and development. Stronger countries might attempt to assert irridentist claims against the weak (e.g., China against Taiwan); or smaller powers may assert themselves against the necessary security framework provided by American bases and United States security presence.

The economic success of the Asian Pacific region has been based on an assumption that political instability will not engulf the region. In general, the Asian economic growth successes have been facilitated by modest military burdens while political stability and regional security have been protected by the U.S. security umbrella and a continuing state of military alert in some of the newly industrializing nations--South Korea and Taiwan. Although historically, the Pacific has been a far from tranquil region, political stability and the absence of dominating security concerns will be required for continued economic success. The social contract between authoritarian regimes and a populace benefitting from economic progress may be increasingly tenuous. Limited political choice, acceptable to the populations of these countries in the past, may become less acceptable as old established leaders pass from the scene. Resolution of the economic dilemmas and the assurance of a favorable political-security environment are thus central agenda issues for the United States and the Asian Pacific Rim countries that have benefitted from past "economic miracles".

At present, the contrasts between the two spheres of East Asia are significant: the dynamic Asian Pacific Rim countries have become the economic showcase of the world while the members of the Soviet Asian alliance endure poor stagnating economies under heavy defense burdens. However, without a thorough-going reappraisal of their economic strategies, the dynamic Asian Pacific nations may find that the economic miracles have run their course.

There are starkly different economic futures now possible, and a credible scenario could be constructed for either extreme:

- An optimistic scenario of economic dynamism would have the Asian Pacific Rim countries continuing to grow albeit with more import orientation and balanced trade with developed and developing countries alike.
- A pessimistic economic scenario of confrontation would have East Asia, led by Japan, continuing its export driven growth strategy with rising trade imbalances, especially with the United States and Asian LDCs, resulting in a reciprocal process of trade restrictive policies and slow growth in GNP and trade.

CHAPTER 1

ASIAN PACIFIC ECONOMIC DEVELOPMENT: THE HISTORICAL PERSPECTIVE (1960-PRESENT)*

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I. INTRODUCTION

The Asian Pacific Rim has been transformed in the past 25 years into a major world center of commerce, industry, and economic activity. The region today rivals North America and Europe in many of the key indicators of economic power. The unprecedented economic achievements of the region have forced governments and firms in North America and Europe to reexamine their policies and practices to remain internationally competitive, and have led to predictions that the countries of the Asian Pacific Rim will eclipse North America and Europe as the center of world economic power and dynamism in the 21st Century.

The major countries of the Asian Pacific Rim include Japan, South Korea, Taiwan, Singapore, Hong Kong, Indonesia, Malaysia, Thailand, the Philippines, and China. These ten countries exhibit vast differences in culture, population, land size, and resource endowments. In terms of income levels, the countries can be classified into four categories. Japan, the only advanced industrialized country in the group, has a per capita income in excess of $10,000 and is the dominant economy of the region. Korea, Taiwan, Singapore, and Hong Kong, so-called newly industrializing countries (NICs), constitute a second tier of countries within the region that are on the verge of entering the ranks of fully industrialized and developed states. These four upper-middle income level countries have per capita incomes ranging from $2,000 to $6,000. Malaysia, Thailand, Indonesia, and the Philippines, four resource-rich members of ASEAN, comprise a third tier of developing countries within the region with per capita income levels ranging from $600 to $1900. China, a country with an immense population in excess of 1 billion and a per capita income level of around $300 represents a potent fourth tier of the region.

These Asian Pacific economies now rank alongside North America and Western Europe as a major center of economic vitality. In 1965, the combined Asian Pacific economies produced $183 billion in goods and services, a level 75 percent below North America (Canada and the United States) and 60 percent below Western Europe (Belgium, France, Germany, Italy, Ireland, the Netherlands, Spain and the United Kingdom). By 1983, total production in the Asian Pacific Rim economies had soared over eight-fold to $1.7 trillion, a level only 50 percent below North American production and less than 30 percent below West European production. 1/ Thus, in less than 20 years the Asian Pacific economies made substantial strides in catching up with the West.

The Asian Pacific countries reduced the income gap with North America and Western Europe by growing at breathtaking rates. Japan and the Asian NICs, in fact, have experienced the world's fastest growth rates since the

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1/ CRS calculations based on World Bank Development Report 1985.

1950s. In addition, Indonesia, Malaysia, and Thailand were members of the second fastest growth group. 2/

Individual country growth records have shown considerable variation. As shown in Table 1, from 1965-1973 the annual average growth rate in Asian Pacific Rim countries ranged from a low of 5 percent in the Philippines to a high of 13 percent in Singapore. During this period Japan and Korea averaged 10 percent annual growth, twice the rate achieved by Germany and three times the rate achieved by the United States. Ever since the oil price rises of 1973, Asian Pacific performance has outpaced performance in other areas of the world by a wide margin. From 1973-1984 economic growth ranged from 5 percent in the Philippines to 9 percent in Hong Kong. At the same time average growth rates were dropping around the world. In the United States, Italy, and Germany economic activity slowed down to around 2 percent a year. Even Japan's slowdown to a little over 4 percent was twice as rapid as growth in these other industrialized countries.

TABLE 1. Gross Domestic Product, Selected Countries
Average Annual Growth Rate (Percent)

	1965-73	1973-1984
China	7.8	6.6
Indonesia	8.1	6.8
Philippines	5.4	4.8
Thailand	7.8	6.8
Malaysia	6.7	7.3
South Korea	10.0	7.2
Hong Kong	7.9	9.1
Singapore	13.0	8.2
Japan	9.8	4.3
Germany	4.6	2.0
United States	3.2	2.3
Italy	5.2	2.1

Source: World Development Report, 1986

If there were a continuation of current trends, by the year 2000 the Asian Pacific economies likely will account for 25 percent of the world's production and North America a little less than 30 percent. Possessing over half the world's total production, the interaction of these two regions will be a dominant force in world trade and financial flows. Although North America's ties to Europe will remain strong, the radical transformation of the Asian Pacific region has set the stage for a new era in international economic competition.

The emergence of high quality and low priced competition from the Pacific Rim, particularly from Japan and the NICs, will require Western producers to increase their presence in Asian markets to keep abreast of

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2/ Hughes, Helen. Policy Lessons of the Development Experience. Group of Thirty, Occasional Paper 16, New York, 1985. p. 2.

new product developments and to intensify efforts to remain competitive in both domestic and foreign markets. If Western producers fail to participate actively in the growth of Asian markets, they likely will lose the ability to meet Asian competition in their home markets. 3/

The new competition from the Asian Pacific Rim is even more startling if viewed in a longer term context. From the end of World War II through the early 1960s, conditions in the Asian Pacific region were characterized by violence, revolutionary enthusiasm, strong communist parties, and numerous territorial disputes. 4/ Today greater peace, prosperity, and stability reigns in this region. Rapid economic growth has been an important ingredient driving the transformation of the region. This chapter surveys some of the major factors underlying the region's economic success, highlights the economic challenges to continuing prosperity in the region, and assesses broad factors that could affect the future growth prospects of the region.

II. SOURCES OF ECONOMIC GROWTH

There is no universal agreement on how economic growth occurs. In general, government, business, and labor all have key roles to play. Governments must adopt appropriate economic policies and provide a stable and predictable environment. The labor force needs to be hard-working, educable, adaptable, and willing to sacrifice some current consumption for future rewards. Business must be willing to risk domestic investment and stay attuned to developments in manufacturing processes and market trends and constantly try to cut costswithout sacrificing quality.

The Asian Pacific countries have been among the most successful in developing various strategies to promote economic growth. A variety of factors help explain the success of the Asian Pacific economies. The most important are indigenous to the countries of the region. Governments have adopted outward-looking trade and industrialization strategies and promoted high rates of savings. Implementation of these policies has been facilitated by a tradition of strong government ("soft authoritarianism") and Confucian values. At the same time the most successful governments have not stifled private sector initiative. Governments, rather, have cooperated with business leaders to achieve national economic objectives. National policies and attributes supportive of economic growth have been reinforced by the regions's complementary resource base and access to the U.S. market.

3/ See the chapter by Dick K. Nanto, Japan's Growth Formula: A Time For Reappraisal.

4/ Overholt, William H. The Moderation of Politics in the Pacific Basin. In The Pacific Basin: New Challenges for the United States. Proceedings of the Academy of Political Science. New York, Columbia University, 1986.

A. Export-Orientation

The most successful countries in the region have promoted industries geared to exporting. Concentrating on exporting has multiple benefits. It provides the means to overcome small domestic markets by achieving economies of scale and volume sales, imposes cost consciousness on firms, encourages private sector vitality, and eases foreign exchange limitations on development. Although outward-looking export policies clearly help a country meet international standards of efficiency and serve as a guide to proper resource allocation, they alone are not sufficient for development success.

As shown in Table 2, the Asian Pacific region's share of world exports has more than doubled from 1960 to 1984, rising from 7.5 percent to 17 percent. Japan led the way by accounting for more than half of that growth. By contrast, the U.S. share of world exports increased only 2.5 percentage points and the European Community's (EC) share dropped by 1 percentage point. Due to the expanding membership of the EC from five countries in 1960 to nine countries by 1984, the figures may tend to distort the relative decline of the EC in world trade.

TABLE 2. Asian Pacific Share of World Exports
($ millions and percent)

Source: United Nations Trade Data

Japan's trade and industrialization strategy from the 1950s to 1970s included trade and investment restrictions on foreign competition that could undercut domestic production. Comparative advantage was not viewed as determined by existing endowments of land, labor and capital but as something that could be induced and created through government incentives. Since the industries that are able to export are also the ones with the highest rates of productivity increase, economic growth was generated in practice through shifts in Japan's economic structure toward industries that export a sizeable portion of their output. 5/ Japan's strategy has been copied most successfully by Korea and Taiwan, but it has influenced all other countries in the region.

Although Japan today exports less than 20 percent of its GNP, a much smaller share than most other industrialized countries, foreign sales account for over half of the output of industries such as autos, watches, videocassette recorders, and lathes. Since 1983 nearly all of Japan's

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5/ Krause, Lawrence B., and Sueo Sekiguchi. Japan and the World Economy. In Patrick, Hugh, and Henry Rosovsky, eds. Asia's New Giant. Washington, The Brookings Institution, 1975. p. 398.

economic growth has been accounted for by the trade sector. Moreover, success in the international market place is critical for a firm's long-term growth prospects within Japan. 6/

High economic growth rates in the Asian NICs have been propelled by a rising level of manufactured exports. In each country, manufactured exports have been growing faster than total exports and currently account for the bulk of total exports. Korea's exports of manufactures as a percent of total exports increased from 61 percent in 1965 to 92 percent in 1984. For the same period, the increase in manufactures in Taiwan was from 43 percent to 94 percent, in Singapore from 31 percent to 53 percent, and in Hong Kong from 93 to 95 percent. 7/ The increases in Korea and Taiwan were the most dramatic and coincided with each country's shift to export-led growth strategies in the early 1960s. Hong Kong started its industrialization program much earlier and being resource poor, its share of manufactured exports in total exports was already large in the early 1960s. Singapore's lower share of manufactured exports is due to its significant exports of petroleum.

Three of the NICs -- Taiwan, Korea, and Singapore -- went through an import substitution stage before adopting outward-looking growth policies. Import substitution is associated with an array of policies designed to protect and promote infant industries. Inevitably import substitution measures such as overvalued exchange rates and import quotas discriminate against exports. Due to historical circumstances, Hong Kong is the only successful developing country that did not go through an import substitution phase before adopting an export orientation. 8/

The four ASEAN countries have not matched the export growth rates of the NICs but their performances have generally surpassed countries in Latin America and Africa. ASEAN policies have not been as outward-looking as the NICs because their governments have encountered more economic and political constraints. 9/

Indonesia's rate of growth of exports has been impressive. In the 1970s, the economy grew rapidly with exports leading the way. The growth of exports, however, was less due to the adoption of outward-looking policies than to a tenfold increase in the price of oil, the commodity that accounts for 80 percent of Indonesia's total exports, and sustained capital inflows. Indonesia's industrialization strategy remains primarily import-substitution oriented with high-levels of protection and an often overvalued exchange rate. To lay the foundation for long-term export-

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6/ Nanto, Dick K. Japan's Growth Formula: A Time For Reappraisal.

7/ See the chapter by William H. Cooper, Export-Led Development: The East Asian NICS.

8/ Chen, Edward. The Newly Industrializing Countries in Asia: Growth Experience and Prospects. In Asian Economic Development--Present and Future. University of California Press, 1985.

9/ See chapter by Larry A. Niksch, Indonesia, Malaysia, the Philippines, and Thailand.

led growth, the government must overcome formidable political obstacles to reducing protection and restructuring of their industry. 10/

The Philippines is similar to Indonesia in not having successfully made the transition from import-substitution to a strategy of export-led growth. Due substantially to high levels of protection and an overvalued exchange rate, predominantly capital intensive investments have been concentrated in urban areas, thereby exacerbating unemployment and regional income disparities. Efforts in the 1970s to adopt more outward looking policies have been slow to show improvement. Philippine growth in the 1970s did not become export-led as GNP and exports grew at the same rates. Efforts in the 1980s to restructure industry and end discrimination against the agricultural sector, of course, are severely constrained by political upheaval. 11/

Unlike Indonesia and the Philippines, Thailand has generally avoided excessive protection of its import-competing industries and severe discrimination against its exports of manufactures and agricultural products. With exports expanding at over 12 percent in real terms and national output growing in excess of 6 percent, Thailand experienced export-led growth between 1970 and 1982. Solid diversification of its export mix has also allowed Thailand to weather unfavorable external events such as the OPEC oil price increases and turndowns in world economic growth. This success is attributed by some to the stability and skills of Thai government "technocrats." 12/

Malaysia is similar to Thailand in exhibiting a pattern of moderate protectionism and government intervention. Exports in real terms grew at close to 7 percent between 1970-1881, a rate equivalent to real GNP growth. Exports of tin, rubber, palm oil, logs, and petroleum have spurred the growth in exports, but manufacturing has also grown rapidly. Although Malaysia has protected import-competing industries with high tariffs, it has avoided some of the most onerous elements of an import-substitution strategy such as an overvalued exchange rate. 13/

The significance of changes in China's dependence on foreign trade is much less clear than in the other Asian Pacific Rim countries. Until recently, the value of China's exports as a percentage of GNP was only about 5 percent. Since its switch in 1979 to more outward-looking policies, China's export dependence has doubled and is now comparable to the United States. Whether China's modified Soviet-type economic system is

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10/ Glassburner, Bruce. ASEAN's Other Four: Economic Policy and Performance Since 1970. In Asian Economic Development -- Present and Future. University of California Press, 1985. p. 168.

11/ Glassburner, p. 173.

12/ Glassburner, p. 178 and 183.

13/ Glassburner, p. 184 and 188.

compatible with only limited integration into the capitalist world trading system, however, remains a point of contention today. 14/

B. Savings and Investment

The most successful countries in the region have also adopted policies to promote investment and domestic savings. Resources have been channeled to strengthen the industrial sector at the expense of private consumption. Some analysts maintain that an element of authoritarian government or one-party rule has helped Asian Pacific Rim governments reject political demands for greater personal consumption.

In general, a country that saves and invests more than 20 percent of its gross national product (GNP) is well on its way to self-sustaining development. The NICs and ASEAN countries increased their gross domestic savings as a share of national output from 13 percent in 1960 to 24 percent in 1982. Gross domestic investment as a share of GDP also rose from 15 percent in 1960 to around 27 percent in 1982. Foreign borrowing, particularly in Korea and the Philippines, allowed many of the countries to invest more than they saved. The record of individual countries of course varied. The ratio of investment to gross national product between 1960 and 1982 grew from 11 percent to 29 percent in South Korea, from 18 to 29 percent in Hong Kong, from 14 to 34 percent in Malaysia, from 11 to 46 percent in Singapore, from 20 to 26 percent in Taiwan, and from 16 to 21 percent in Thailand. 15/

Savings and investment activity in China and Japan have also been at extremely high levels since 1960. Since 1960 China has saved and invested around 30 percent of its national output, an exceptionally high level for a poor country. Japan has maintained during this period one of the world's highest savings and investment ratios by keeping interest rates for business loans low and those for consumers high. In addition, government spending on social infrastructure lagged behind expenditures on industrial infrastructure that would make the country more competitive internationally. 16/

C. Soft-Authoritarianism and Capitalism

14/ See Dernberger, Robert F. The State-Planned, Centralized System: China, North Korea, Vietnam. In Asian Economic Development -- Present and Future. University of California Press, 1985.

15/ Okita, Saburo. Pacific Development and Its Implications for the World Economy. In The Pacific Basin: New Challenges for the United States. Proceedings of the Academy of Political Science. New York, Columbia University, 1986. p. 24-25.

16/ See Nanto, p. 11-12.

Governments in the Asian Pacific region have played key roles in fostering development. Economic growth and catching up with the West have been important national objectives. Strong economic bureaucracies with considerable power to shape policy, including the targeting of specific industries, close government-business relations, and establishment of public sector enterprises are characteristics shared in varying degrees by most of these ten countries.

Unlike socialist countries that nave attempted to direct economic activity through centralized planning, Asian Pacific governments have directed economic activity by keeping a watchful eye on prices and world markets. Although they have had a basic market orientation and have supported the development of a vigorous private sector, they have been more interventionist and active than many market-oriented governments in the West in setting economic and social policies, and in creating economic institutions and material incentives for development.

Based on a comparison of the political and economic underpinnings of high growth in Japan, Taiwan and Korea, Chalmers Johnson has pinpointed the coexistence of soft authoritarianism and capitalism as the key elements of economic success. Johnson's structural model of East-Asian high-growth systems has four elements: stable rule by a political-bureaucratic elite not acceding to political demands that would undermine economic growth; cooperation between public and private sectors under the overall guidance of consensually agreed upon national economic objectives; a government that understands the need to use and respect methods of economic intervention based on the price mechanism, and heavy and continuing investment in education for everyone. Johnson demonstrates how each of these elements exists in varying ways in the Japanese, Taiwanese, and Korean systems. 17/

Many aspects of Johnson's model arguably could be applied to Singapore, Malaysia, and Hong Kong. High-growth economic systems based on the coexistence of soft authoritarianism and capitalism provide a formidable challenge to both Soviet-type command economies and Western capitalistic systems.

D. Confucianism

The Confucian tradition, an Asian value system concerned with ethical behavior and correct interpersonal group relations, is a final indigenous attribute thought to support economic development in much of the region. Many observers believe that confucianism undergirds support for authoritarian rule, company loyalty, hard work, educational attainment, and frugality -- factors that are generally believed conducive to high growth. Perhaps more important is the fact that acceptance of strong government and a hierarchical system contributes to the implementation of policies.

17/ Johnson, Chalmers. Political Institutions and Economic Performance: The Government-Business Relationship in Japan, South Korea, and Taiwan. In Asian Economic Development -- Present and Future. University of California Press, 1985. p. 71.

The argument also can be made that cultural characteristics are poor indicators of growth capacity. Until the 1960s, for example, Korea was regarded as an economic basket case because it was thought to be too concerned with spiritual issues to consider business activities and economic growth important. Korean and Taiwanese economic performance did not improve, in fact, until both countries abandoned import-substitution policies in the early 1960s. The case can be made that such values alone will not foster economic development in the absence of the necessary economic incentives and policies, but that they may encourage behavioral patterns that facilitate economic growth. 18/

E. Complementary Resources

While development in the region has been spurred primarily by the efforts of the individual countries, a complementary division of labor among the region's economies and growing interdependence support the economic dynamism of the region. More than half the trade of the Asian Pacific Rim countries is with the other countries of the region. 19/

Japan, as the dominant economic power of the region, has had a tremendous impact on the Pacific Rim economies. It has been felt through Japan's substantial growth in demand for raw materials, energy, and more recently light manufactures. It has also been transmitted through flows of capital, technology, and high-quality,low-cost machinery. Japan has also provided the other countries in the region with foreign aid. Perhaps most importantly, Japan has also served as an example to other countries that it is possible for Asian countries to industrialize.

The second, third, and fourth tiers of the region provide Japan with more than energy, raw materials and components to support its industrial economy. As Japan begins to lose comparative advantage in specific areas, the rest of the Asian Pacific Rim provides a platform for Japanese foreign investment in activities it can no longer do competitively at home. In addition, the rest of the region has become critical for Japan's testing of new products and learning curve strategy of development. 20/ It is not surprising that these nine countries now account for about three-quarters of all manufactured exports from developing countries. While these countries account for only about 10 percent of the world's manufactured exports, they also undoubtedly account for a much higher proportion of labor-intensive products. 21/

18/ Asia-Pacific Report: Trends, Issues, Challenges. Honolulu, Hawaii, East-West Center, 1986. p. 18-21.

19/ Drysdale, Peter. The Pacific Basin and Its Economic Vitality. In The Pacific Basin: New Challenges for the United States. Proceedings of the Academy of Political Science. New York, Columbia University Press, 1986. p. 14.

20/ Heginbotham, Erland. The Real East Asia Edge. SAIS Review, Spring 1984. p. 15-29.

21/ Drysdale, p. 14.

The NICs initially concentrated on labor-intensive products in the 1960s as Japanese wages and skill levels began to rise. Now they are rapidly expanding their production of more skill and capital intensive consumer durables and capital goods. This transition is now enabling other ASEAN countries and China to expand their production of labor-intensive industries. In addition, Singapore and Hong Kong serve as major financial and service centers for the region and Taiwan and Korea are increasingly active in assisting other countries in the region with direct investment and technology tie-ups.

With lower wage rates and abundant natural resources, many of the labor-intensive and processing industries are shifting to the ASEAN countries and China. To date, however, the vast majority of manufactured goods are still produced for the domestic market. This is most evident in Indonesia where less than 5 percent of total exports are manufactured goods. The other countries have shown marked improvement. Manufactured goods accounted for 49 percent of total exports from the Philippines in 1982 (up from 4 percent in 1960), 29 percent in Thailand (up from 2 percent in 1960) and 23 percent in Malaysia (up from 6 percent in 1960).22/

F. Access to the U.S. Market

The most important contribution the United States has made to foster the Asian Pacific regional division of labor has been to serve as its very best customer. 23/ The United States is the number one market for Korea, Japan, the Philippines, Singapore, Taiwan, and Hong Kong and is an important market for the rest.

U.S. imports from the Asian Pacific Rim are predominantly manufactured goods. U.S. imports from Indonesia, which consist primarily of oil and rubber, are the major exception. Japan's biggest exports, of course, are cars, consumer electronics, office equipment, computers, and steel. The Asian NICs as they move up the technology ladder are now competing with Japan for market share in autos and sophisticated consumer electronics. The ASEAN countries and China mostly export labor-intensive products including clothing, textiles, and electrical components.

Imports from Asian Pacific Rim countries totalled $130 billion in 1985 or more than 35 percent of total U.S. imports. This represents a more than 20 percentage point increase since 1960 when imports from the region totalled $2 billion. Some portion of the increase is accounted for by U.S. multinationals mostly involved in production of electronics or processing crude oil and natural resources.

By contrast, U.S. exports to Pacific Rim countries as a percentage of total U.S. exports have increased only 9 percentage points, from 14 percent of total U.S. exports in 1960 to 23 percent in 1985. As a result, the region's economies today account for more than half of the $150 billion global U.S. trade deficit. 24/ While traditionally the United States

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22/ East-West Center, p. 24.

23/ Okita, p. 27.

24/ CRS calculations based on Department of Commerce data.

has tolerated a relative inequality in market access opportunities, growing trade deficits have resulted in pressures to assure that reciprocal market opportunities exist. This has meant that the Asian NICs and ASEAN countries will not have the same advantage Japan enjoyed -- U.S. toleration of a development strategy based on protected domestic markets.

III. ECONOMIC CHALLENGES

Each of the Asian Pacific economies faces economic challenges to a continuation of high growth. Japan, the NICs, and China all face major turning points and great uncertainty in their efforts to develop economically. The ASEAN countries, particularly Indonesia and the Philippines, remain subject to deep-rooted economic and political development constraints. In most general terms, the challenges result from changing conditions that will make it difficult for governments to duplicate the high growth experience of the 1960s and 1970s. Less willingness by the United States and Europe to allow Asian Pacific countries to adopt and maintain export-based growth with domestic protectionist policies, and predictions of slower world economic growth for the remainder of the 20th Century also will have important effects on growth in the region.

A. Japan

Dealing with a rising level of foreign protectionism is Japan's number one challenge. Japan's exports of a broad spectrum of manufactured goods have caused significant disruptions in its two most important markets, the United States and Europe. The disruptions have been met with formal and informal trade barriers. Some analysts estimate that nearly 60 percent of Japan's exports now face foreign restrictions. 25/

Restrictions on Japan's exports have also been a reaction to Japan's composition of trade. As a resource-poor country, Japan has concentrated on producing high-value-added manufactured goods. While nearly all of Japan's exports are manufactured products, less than one-fourth of Japan's imports are manufactured goods. In contrast, manufactured goods account for at least 50 percent of total imports of all other advanced industrialized countries. Trade tensions have been exacerbated as a result.

A panel of advisers to Prime Minister Nakasone recently submitted a report (the Maekawa Commission Report) detailing the need to alter Japan's export-oriented trade structure. The report outlines principles for transforming Japan's economy to growth based on domestic demand. Such a transformation would require substantial increases in domestic expenditures on leisure and housing. The possibilities for restructuring, however, are constrained by efforts to reduce budget deficits and declining government control over the activities of its aggressive exporters. Without a fundamental transformation, Japan is likely to encounter increased protectionist pressures in the future.

25/ Woronoff, Jon. Japan's Structural Shift From Exports to Domestic Demand. In U.S. Congress. Joint Economic Committee. Japan's Economy and Trade with the United States. 99th Cong., 1st sess., Washington, 1986. p. 67.

B. NICs

Similar problems confront the Asian NICs. 26/ The threat of protectionism has grown in proportion to the success of their export-oriented industrialization strategies. Due to Japan's success, they also face intensified scrutiny from the United States and Europe to ensure that their competitive success is not facilitated by unfair trading practices. Less dependence on foreign trade in general and more diversified industrial structures are key challenges facing the NICs.

The economic transformation of South Korea and Taiwan, in particular, has been spurred by export-oriented industrialization strategies similar to Japan's. Import protection, the screening of foreign investments, and export promotion incentives in both countries have been important tools in efforts to foster the development of designated industries. The strategies have helped them overcome the limitations of the small size of their domestic markets, but also increased their trade-dependence to record levels.

Both countries carved out a niche originally as low-cost and labor-intensive manufacturing centers. Rising labor costs prompted authorities in both countries to emphasize the development of more capital-intensive and technologically sophisticated industries. A very high dependence on the U.S. market (about one-third of South Korea's total exports and one-half of Taiwan's go to the United States) has prompted efforts to diversify export markets. Current prospects for market diversification, however, are not favorable in light of the rapid appreciation of the yen vis-a-vis the dollar (the currencies of Taiwan and South Korea are pegged substantially to the dollar), thereby increasing the attractiveness of their products relative to Japan's in the U.S. market.

In recent years, as both countries' trade surplus with the United States has escalated rapidly, U.S. pressures designed to increase the pace of trade liberalization in Taiwan and South Korea have intensified. Overcoming bureaucratic and private sector resistance to an accelerated liberalization schedule will be increasingly critical for South Korea and Taiwan if they are to maintain access to foreign markets in the future. Unlike Japan, neither country has the luxury of inattention from U.S. business and government.

In addition to being vulnerable to foreign restrictions and pressures to liberalize their markets, South Korea and Taiwan remain vulnerable to rising commodity prices or supply interruptions. Although both economies adjusted to the two oil price shocks in the 1970s by increasing exports, greater sensitivity of their major trading partners to future export surges could undermine a similar strategy.

Hong Kong and Singapore are the two NICs closest to achieving fully developed market economy status. Currently, both of these city-states en-

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26/ This sections draws heavily on the East-West Center report, p. 22-24.

joy per capita incomes in excess of $6,000, a level equivalent to Italy's and greater than Ireland's and Spain's.

Although both countries have developed into major regional centers for finance and services, their development strategies have varied. Hong Kong's economic growth has been guided by free trade, a lack of government intervention, and low tax and conservative fiscal policies. Having little arable land and virtually no natural resources, Hong Kong depends on trade for survival. As a major center for investment, trade and contact with China, Hong Kong stands to benefit from China's new outward orientation and economic growth.

The government of Singapore has been much more heavily involved in economic development, establishing state corporations and in setting wage rates and labor regulations. As a predominantly service-oriented economy involved in shipping, banking, insurance, storage and distribution, Singapore has expanded its traditional reliance on services by rapidly industrializing. Shipbuilding and repair and electronics have been among the leading manufacturing sectors. New higher-technology industries such as aircraft components and computer disc drives are currently being encouraged. Unlike Hong Kong which has relied primarily on domestic capital to support industrial investments, Singapore has actively and successfully attracted foreign investment.

Both Hong Kong and Singapore have experienced economic set-backs in recent years. Efforts to control uncharacteristic budget deficits in Hong Kong from 1983-1985 led to a steep cutback in government expenditures. This cutback, in turn, has hurt Hong Kong's overall growth with the construction industry being particularly affected. Investor confidence was also adversely affected for a period of time by prolonged British-China negotiations over the colony's future. Even with the completion of the negotiations, China remains a major worry. China's economy is running a substantial global trade deficit and has been hurt by falling oil prices. Because China is Hong Kong's second major trading partner, an economic downturn there would have significant effects on Hong Kong's economy.

For a period Singapore benefitted from Hong Kong's difficulties, but by 1985 economic growth had ground to a halt. Industries such as petroleum-refining, electronics, and shipbuilding were all adversely affected by worldwide gluts in supplies. In addition, rising costs, particularly undercut some of Singapore's competitiveness. To up-grade its small economy to meet growing international competition, particularly from other NICs, Singapore is striving to move beyond a production base to becoming an international total business center. Along these lines, the government is attempting to attract companies to establish operational headquarters, which are responsible for subsidiaries throughout the Pacific Rim. Greater emphasis is also being placed on promotion of services such as construction firms building hotels in China or salvage firms operating in the Middle East.

The Asian NICs, in short, are all in the midst of transforming their economies to a higher stage of development. Policies developed to accomplish this transformation will have to take account of different economic interests and sensitivities of their major trading partners than prevailed in the 1960s and 1970s.

C. ASEAN

In contrast to the resource-poor NICs, economic development in Indonesia, Malaysia, the Philippines, and Thailand has been bolstered by the availability of raw materials and primary products. 27/ Products such as petroleum, tin, rubber, palm oil, coconut products, rice, sugar, and tapioca have been the mainstays of their economies. Coping with price instability for these products is a perennial economic challenge for these countries.

Growth rates in the ASEAN-4 countries, as noted earlier, have not been as spectacular as in the NICs. This can be attributed in part to their larger populations, larger agricultural sectors, and to their more pluralistic societies. Nevertheless, their growth rates have outpaced most other middle-income developing countries. Between 1963 and 1983, Malaysia, Thailand, and Indonesia all averaged around 7-8 percent annual growth rates. The Philippines record of 5 percent was less impressive but still quite respectable compared to any other region of the world. Since 1983 the Philippines record, of course, has been undermined by political and economic turmoil.

Agriculture's share of national income has shown impressive declines in each of these countries. The largest drop has occurred in Indonesia. The share of national income contributed by agriculture was close to 60 percent in 1963 but by 1983 it had dropped to 26 percent. Similar declines for the Philippines were 26 percent to 22 percent, for Thailand 35 to 23 percent, and for Malaysia 30 to 21 percent. Despite the declines, half or more of the labor force in each country is still employed in agriculture.

Although agricultural production has expanded faster than population growth, only Thailand is self-sufficient in food. Greater self-sufficiency is required in order to shift resources, including the growing labor force, into the manufacturing sector. As wage rates rise in the Asian NICs, the labor-intensive manufacturing sector of the ASEAN economies should become more competitive.

To date, however, the vast majority of manufactured goods produced in these countries is still sold in domestic markets. Despite attempts in the Philippines and Indonesia to promote the export of manufactured goods, protection of inefficient industries still undercuts competitiveness. Development of more outward-looking economic policies has been thwarted in the Philippines by corruption and political turmoil. In Indonesia the high value of the rupiah resulting from petroleum exports has undermined its manufacturing competitiveness.

Protection of inefficient industries has been less a problem in Thailand and Malaysia. Both countries try to exploit their labor cost advantage by emphasizing light industries such as textiles and electronics. Malaysia in particular has emphasized exporting from free trade zones and now leads the world in chip assembly partly because three large

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27/ This section draws heavily on the East-West Center report, p. 24-26.

U.S. multinationals have plants there. Both countries are also promoting large-scale industrial projects. Malaysia hopes to become an automobile manufacturer and Thailand is building a major industrial center along its eastern seaboard.

As industrialization progresses, the ASEAN-4 will have to make major investments in industrial infrastructure, including transportation, communication, and utilities. The countries have already made significant strides in social welfare improvements. Education, medical care, and other public services have all been strengthened. At the same time, the benefits of economic growth have not been shared as equitably as in other fast developing Asian Pacific countries.

In sum, all four ASEAN countries face difficult obstacles in matching past growth rates in the decades ahead. Indonesia and the Philippines appear to have the most difficult challenges. Indonesia must reduce protection of its industrial sector and hope that world demand for oil and its traditional export commodities recovers. The Philippines must also restructure its domestic industry, a task made even more difficult by domestic political turmoil. On the other hand, Thailand and Malaysia both have protected their industrial sectors less and have a competent corps of technocrats to help cope with future challenges.

D. China

China, the Pacific Rim's fourth tier, stands in sharp contrast to the other economies of the region. 28/ Viewed in absolute terms, China is already an industrial giant. With a GDP close to $300 billion, China is the eighth largest economy in the world. But its per capita income of around $300 also makes it one of the poorest countries in the world. Major economic reforms initiated in 1979 aim at increasing China's national income to $1 billion by the year 2000. If China can achieve this objective and limit its population increase, then living standards will be increased two to three fold in only two decades.

Restructuring of the economy began under Deng Xiaoping in 1979. The plan was to redirect development from its previous emphasis on heavy industry and defense to agriculture, light industry, science and technology and defense. Rural and agricultural reforms initiated in 1979 have successfully expanded food production and controlled population growth. This success has encouraged the leadership in 1984 to begin a systematic attempt at urban reform and industrial modernization entailing a shift from central, mandatory planning toward local autonomy and financial planning. Market forces combined with indicative planning are to guide an increasingly large portion of economic activity. In 1985, a "technology policy" was announced in order to provide a more effective organization for scientific and research development. Modernization of the military is underway as well, but remains a low priority.

Simultaneous with domestic reforms, China is also opening its economy to the world market. Total trade has grown rapidly, from $21 billion in

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28/ See chapter by John P. Hardt and Jean F. Boone, PRC Modernization and Openness -- A New LDC and Socialist Model For the Pacific.

1978 to $50 billion in 1985. Exports now account for almost 10 percent of China's GDP, a doubling in just five years. Half of China's exports are now purchased by Asian Pacific countries and one-third of China's imports come from Asian Pacific countries. In addition to trade, China is also actively seeking foreign capital, technology, and managerial skills by creating Special Economic Zones (SEZ). By the mid-1980s, total foreign investment was estimated to be around $3.5 billion.

China's domestic reforms and more outward-looking trade and investment policies confront continuing challenges. Many foreign firms doing business in China complain of soaring costs, arbitrary tax and tariff levies, inadequate and expensive labor and numerous other annoyances.29/ Transportation, communications, and energy constraints pose serious obstacles to success. Vested domestic interests, including the state and party bureaucracy, are resistant to greater openness. The next few years will be crucial in determining the extent to which reforms will be implemented. The economic results of current experiments will be an important factor in determining the future course of China's economic system.

IV. OUTLOOK

Both internal and external factors will influence the economic future of the Asian Pacific region. Internally, national authorities will have to adopt and implement policies that lead to efficient resource allocation if high rates of economic growth are to be sustained. A number of Asian Pacific governments have demonstrated the capacity to promote economic growth in the past by blending a form of "soft authoritarian" government with healthy dosages of capitalism. If past is prologue, the probabilities are excellent that this unique combination of factors will allow Asian Pacific economies to outperform their major competitors regardless of the external environment. This is because, in the words of Chalmers Johnson, they have "managed to adapt more effectively and more rationally to any given environment than either their absolutist or their purely capitalist rivals." 30/

Political instability remains the major internal factor that could undermine favorable economic predictions for the region. In many of the Asian Pacific states "the social contract between authoritarian regimes and a populace benefitting from economic progress may be increasingly tenuous . . . as old established leaders pass from the scene." 31/

How well the Asian Pacific economies perform in absolute terms, however, will also depend substantially on the external environment. Growth in world trade and market access conditions, particularly in the United States and Japan, will be a major influence on the level of future economic growth rates in the region.

29/ Firms Doing Business in China Are Stymied By Costs and Hassles. Wall Street Journal, July 17, 1986. p. 1.

30/ Johnson, p. 89.

31/ Hardt, John P., and Jean F. Boone. Policy Prospectus. p. 5.

The United States is now running massive global and bilateral (particularly with Japan) trade deficits that are unsustainable in the long run. Although the causes of U.S. trade deficits lie in domestic economic policies, there is a growing tendency in the United States to focus on unfair foreign trading practices as a significant cause. Proposals to retaliate against unfair trade practices have received serious consideration and some, if implemented, could precipitate a spiral of trade restrictions.

In contrast to the United States, Japan is running record global trade surpluses. As total spending in Japan continues to fall short of total output, its excess savings is exported to the rest of the world. Although this pattern does contribute to enhancing global economic efficiency, it increases political tensions and in the long run is unsustainable. Greater efforts by Japan to consume more at home and make its economy more accessible to imports are needed to avoid an outbreak of protectionism directed at Japan.

Given these factors, a high-growth scenario for the region can be predicted if the United States is able to gain control of its trade deficit and Japan becomes more accessible to imports. Trade disputes undoubtedly will continue to occur but growth rates in the region will be higher than elsewhere. If this occurs, the region by the year 2000 will have almost caught up to North America in combined income. On the other hand, if the U.S. response to its trade deficit becomes protectionist and Japan's market remains resistant to imports, trade and growth in the region could be severely disrupted, thereby undermining the recurrence of export-led growth. 32/

32/ Okita, p. 31.

CHAPTER 2

JAPAN'S GROWTH FORMULA: A TIME FOR REAPPRAISAL*

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Of the nations in the Asian Pacific Rim, Japan has throughout the twentieth century led the way in the rise from industrial backwardness to international economic power. Its relentless ascent from the unconditional surrender on the deck of the U.S.S. Missouri through reconstruction and two decades of soaring economic growth to become the second largest economy in the world has not only made the Japanese the nouveau riche, but it has forced industries in other nations to adjust their own business strategies to cope with the competitive challenges from this seeming economic juggernaut.

This paper provides a selected survey of Japan's economic performance over the past 25 years, looks at some lessons for currently industrializing countries, and then explores prospects for the future and implications for the United States. The purpose of this survey is to develop hypotheses and an agenda for change. (More detailed studies are listed in the footnotes.) Some major conclusions are:

-- During the 1960s and 1970s, Japan experienced unusually rapid economic growth that transformed its economy into the second largest in the world.

-- Japan's growth formula included macro- and microeconomic policies as well as an ability to pursue its own interests without criticism from abroad.

-- Macroeconomic planning and policy provided the framework for rapid economic growth and raised the expectations of businesses.

-- Microeconomic policy included following a model of import substitution/export promotion industrialization in which the major objective was to develop competitive industries across the industrial spectrum.

-- The method by which industrial policy was carried out involved targeting the next generation of potential export industries and inducing their growth through multitudinous decisions on items such as import tariffs, technology licensing, and finance but usually did not include direct government ownership or massive subsidies.

-- A key element of building strong industries was to shield them from foreign competition in their infancy but force them to face fierce competitive battles at home.

-- Some of the favorable conditions Japan enjoyed while it industrialized were a long period of time over which to grow, its small size in world markets and tolerance by more advanced nations of its policies, its ability to acquire advanced technology at a low cost, a long period of world economic expansion, and low requirements for national defense.

-- Japan is now at a new uncertain age that seems to require a complete rethinking of its growth formula. The elements that have changed include heightened protectionism directed at its exports, the growing international character of its economy, the diminished role of government, and the aging of its society.

-- In April 1986, a blue ribbon advisory group reported that the time had come for a major shift in Japan's economic policies and way of life that would require a reduction in dependence on exports and an improvement in the quality of life of the people.

-- The outlook for Japan is for continued growth at about 3 percent per year with the merchandise trade surplus peaking within a year or so. The appreciating yen could put the country in a position similar to Germany's -- a country making products of quality but whose prices are high because of a strong currency. If the yen appreciates to 100 yen per dollar, Japan's GNP would reach approximately $3 trillion with per capita income and wages about twice the American level.

-- Japanese businesses will continue to be major competitors in world markets. American businesses need to adopt an Asian strategy to cope with this competition, and U.S. policy deliberations also should include consideration of the "Japan effect."

I. BACKGROUND

Japan founded its economic strength on its people. Lacking natural resources or a sizable land mass, the country has combined labor, capital, and entrepreneurship to gain a comparative advantage in a range of industries. In some cases, these industries have become world leaders in product development and in manufacturing process improvements. Japanese firms hold major market shares in products such as machine tools, cameras, watches, automobiles, television receivers, and videocassette recorders and still manage to capture nearly half of the new orders for commercial ships. They lead in world steel technology, and their computer industry, which has broken through the dominance of the IBM corporation domestically, is pressing to narrow the American lead in overseas markets.

In the process of becoming a world-class economic power, Japan has racked up massive trade surpluses with other countries of the world. Its $56 billion overall trade surplus in 1985 -- including a $50 billion bilateral surplus with the United States alone-- combined with a similar amount in finance capital that flowed into world investment markets are only indicative of the influence the Japanese economy has on life outside its borders.

For American businesses, moreover, the crucible of competition is shifting from the domestic U.S. marketplace to the East Asian rim. In a variety of products, particularly consumer goods and business equipment, if Western business planners do not keep abreast of new product developments in Asia, they are likely to find themselves confronted by formidable foreign competition offering products still on their own drawing boards -- as was the case with numerically controlled machine tools. If U.S. firms do not contain costs of production or if they allow slippage in quality control, they are likely to face competitive products from Asia not only with lower prices but of higher quality -- in automobiles, for example. If American firms do not maintain their market share in Asian markets, it is likely only a matter of time before they will be facing similar shrinkage of market share at home -- in personal computers, for example.

This competition from the Asian Pacific Rim is breaking established patterns and upsetting some economic interests. Much as was the case with the oil crises in the 1970s, this competition is galvanizing U.S. society and shaking it out of its lethargy. The oil crises exposed the waste in energy use throughout the American economy and the vulnerability caused by dependence on unstable sources of petroleum. Once the painful adjustments were made, however, society became much more efficient and prudent in its use of energy, and supply sources were broadened.

The new economic competition from the Asian Pacific Rim, particularly from Japan, has had a similar effect on the American economy. It exposed several areas of weakness in manufacturing practices, government economic policy, labor relations, and business strategies. While the adjustments required have not been without pain, once they have been made, the results should contribute to a society much more healthy in the long-term, more competitive, and better not only for the consumer but for businesses as well. 1/

II. JAPAN'S GROWTH FORMULA

A. Historical Development

Until the 1960s, Japan was primarily preoccupied with reconstruction and recovery from the devastation of World War II. Despite intense Allied bombing and a half-hearted effort to use Japanese industrial capacity as reparations for other Pacific nations, Japan was able to restore most of its industrial strength. The process, however, took more than a decade. The country did not recover its prewar level of national production until about 1954. If

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1/ For some examples of the effect of Japanese competition on U.S. business see: Schonberger, Richard J. Japanese Manufacturing Techniques. New York, The Free Press, 1982. Numerous articles in the Harvard Business Review, such as: Whitney, Daniel E. Real Robots Do Need Jigs. Vol. 64, May-June, 1986. pp. 110-116. Or Hamel, Gary and C. K. Prahalad. Do You Really Have a Global Strategy? Vol. 63, July-Aug, 1985. p. 139-48.

the prewar peaks of 1917 and 1937 are extrapolated forward, Japan did not recover the growth lost during the war until 1962, more than fifteen years after the war had ended. 2/ Japan's true postwar economic growth, therefore, extends from the early 1960s.

As Japan stepped into the 1960s, government leaders and economic planners proposed to double national income over the decade. The economic blue print called for a growth rate of 7-8 percent per year to raise gross national product from 20 to 40 trillion yen ($111 billion). While such rapid expansion was virtually unprecedented in the modern history of major economies, Japan had actually been logging such rates of growth during its recovery period, although such rates were expected to fall once recovery and rehabilitation were complete.

Much to the delight of the ruling Liberal Democratic Party, however, the forecasts of the planners could scarcely keep up with actual economic growth. 3/ The economy expanded so fast that a new plan had to be announced for 1964-68. And before the decade ended, yet two more new plans had to be constructed. Actual real growth rates over the period averaged 11 percent per year.

While the domestic economy surged forward, parallel performance was being recorded in the export sector. During the 1960s, the dollar value of Japan's exports grew at an average annual rate of 16.9 percent (before adjusting for inflation), more than 75 percent faster than the average of all non-Communist countries. By 1970, Japan's exports had risen to account for 6.8 percent of all free-world exports, up considerably from the 3.6 percent in 1960. 4/ By 1965, moreover, surpluses began to appear in the country's merchandise trade accounts, including a developing bilateral surplus with the United States.

As the 1970s began, the world began to take note of the "emerging Japanese superstate." 5/ The country's economy continued to rush forward at record-setting, double-digit rates until the Arab oil embargo of 1973 (followed by world-wide shortages of food and basic minerals) slammed on the brakes. Suddenly Japan's industries were exposed to the same economic disruptions faced by other nations of the world, and growth rates dropped from 9 percent per year in 1973 to a negative 1 percent in 1974 before recovering to 5 percent

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2/ Ohkawa, Kazushi and Henry Rosovsky. Japanese Economic Growth. Stanford, Stanford University Press, 1973. p. 29-30.

3/ Watanabe, Tsunehiko, "National Planning and Economic Development: A Critical Review of the Japanese Experience," Economic Planning, v. 10 (1-2), p. 21-51.

4/ International Monetary Fund. International Financial Statistics, May 1977. p. 56-57.

5/ Kahn, Herman. The Emerging Japanese Superstate, Challenge and Response. Englewood Cliffs, N.J., Prentice Hall, 1970. p. 174.

over the second half of the decade and then falling to 3-4 percent in the 1980s.

The economic shocks of the 1970s reined in Japan's surging growth rate to a level comparable to that of any other industrialized country. The phenomenal postwar growth spurt had ended.

Over the three decades of rapid growth, however, the economy had been transformed. A child born in 1945 entered a society nearly starving on a diet consisting mostly of rice gruel mixed with corn received as food aid from the United States. By the time the child reached 10 years of age in 1955, per capita income would have risen to about $22 per month (compared with $10 per month in 1940). By age 20 in 1965, it would have climbed to $75 per month, and then to $366 by age 30 in 1975. By age 40 in 1985, per capita income would have risen to more than $900 per month or almost $11,000 per year.

Income levels for Japanese now are slightly below but comparable to those in the United States and Western Europe. With its GNP of $1.3 trillion, roughly the size of that of the Soviet Union, Japan has joined the exclusive club of the developed nations of the world.

This phenomenal economic experience by Japan did not occur in isolation. The country relied heavily on an expanding world economy and liberalizing export and import markets. The voracious appetite of Japanese industry for raw materials and petroleum forced it to seek stable supplies and stimulated development of mining and mineral industries in other countries. 6/ Coal from Appalachia with iron ore from Australia were used to produce steel. Crude oil from Indonesia and Brunei supplements that from the Middle East. And the Sino-Japanese trade agreements were founded on the concept that Japan would buy coal and oil from China in exchange for manufactured products. 7/

Export demand also was important. Yet the widely held perception both within and without Japan that the primary force for development has been the drive to "export or perish" is not completely correct. Japan actually relies less on export demand than many other nations of the world. In 1985, for example, it exported 17 percent of its GNP compared with 24 percent for France, 36 percent for West Germany, 30 for the United Kingdom, 30 for Canada, and 63 percent for the Netherlands. Japan exports about the same proportion of its GNP as Australia, and few would characterize Australia as

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6/ Vernon, Raymond. Two Hungry Giants: The United States and Japan in the Quest for Oil and Ores. Cambridge, MA, Harvard University Press, 1983.

7/ Nanto, Richard K. and Hong N. Kim. Sino-Japanese Economic Relations. Journal of Northeast Asian Studies, Vol. 4, Fall 1985. p. 29-47.

being export-led. The United States at 7 percent, however, exports a considerably smaller share of its GNP than Japan. 8/

In terms of overall markets, therefore, Japan is less dependent on foreign trade than many other industrialized countries of the world. The vast bulk of demand has been domestically generated. For specific industries, however, international export markets are extremely important. Foreign sales account for about half of the output of the Japanese automobile industry, and more than half of the production of watches, videocassette recorders, and lathes.

During the 1980s, moreover, the lack of growth in domestic markets has forced producers to look abroad. Nearly all of Japan's economic growth between 1983 and 1986 has been accounted for by increasing net exports. Recent economic growth, therefore, has been export-led.

Export markets, moreover, have allowed Japanese corporations to continue their high growth policies even after domestic markets became saturated. And success in export markets has been the final measure of the viability of a firm or product line in Japan. Furthermore, without exports there could be no imports. Without imports, the country certainly would not perish, but its standard of living would have to be drastically lower.

B. Behind the post World War II boom

Just as Japan's transformation from an exporter of silk stockings to computer systems did not occur in international isolation, Japan's individual businesses did not move from making shoddy imitations of Singer sewing machines to Mazda RX7s without some government support. The government's role came into play primarily at two levels in promoting economic growth. The first was the macroeconomic level or the general economic environment in which all firms operated. The second was at the microeconomic level or in specific policies aimed at particular segments within the economy.

The growth formula pursued by the Japanese government was based on several key assumptions. There were:

-- A domestic consensus that gave priority to industrial growth and exports over domestic consumption.

-- A willingness on the part of the United States to allow Japan to pursue its economic objectives while providing a strategic nuclear (and conventional) shield and access to U.S. markets, while tolerating Japan's remaining protection of its home markets.

8/ Based on International Monetary Fund. International Financial Statistics, March 1986.

-- Acceptance and tolerance by other nations of Japan's growing economic influence, export surpluses, and seemingly protectionist attitudes.

-- Acceptance and tolerance by other Asian nations of Japan's growing role in their economies, particularly in direct investments, economic and technological assistance, and export thrusts.

-- Access to supplies of raw materials and stability in prices of inputs into the Japanese industrial machine.

The question facing Japan now is whether these assumptions have changed, and, if so, what that implies for the country's future. We explore this question by first reviewing Japan's formula for growth.

1. Macroeconomic Policies

For macroeconomic policies, Japan relied essentially on Keynesianism tempered with considerable learning by doing. The tools used have been traditional fiscal policies interspersed with more ready intervention into markets, particularly financial and foreign exchange markets. Markets were stimulated by such mundane measures as public works spending and tax cuts, while the exchange rate was kept at 360 yen per dollar from 1949 to 1971 through vigorous controls over foreign transactions and direct intervention into exchange markets. The government also often allowed cartels to operate. 9/

The government's key role, however, has been to raise expectations in the private sector with respect to future growth and to tilt economic development toward the industrial sector and away from household consumption. The income-doubling plan announced at the beginning of the 1960s, for example, awoke businesses to the potential for growth in the domestic economy and the need to invest to keep up with competitors. The booming economy assured that errors leading to overbuilding capacity would quickly be overtaken by growth, while errors resulting in underbuilding capacity could be disastrous in terms of maintaining market share. Japanese companies quickly adopted policies that were biased toward rapid growth -- even in times of recession.

Stringent controls on foreign exchange, prior to 1980, moreover, kept financial capital at home. Private savings generated by rapid growth in income, an inadequate social security system, and tax incentives were channeled into the industrial sector where they were invested domestically rather than abroad. Government financial institutions, such as the Post Office which took in savings and the Japan Development Bank which loaned them out, assisted in funnelling

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9/ See: Yamamura, Kozo. Economic policy in Postwar Japan. Berkeley, University of California Press, 1967.

savings from the household and agricultural sectors to the business sector.

During the 1960s and 1970s, furthermore, interest rates for business loans were kept low while those for consumers were high. The prime rate of interest for businesses was kept at 7 to 9 percent, while interest on consumer loans guaranteed by salary alone ranged from 60 to more than 100 percent. Home mortgages were difficult to obtain and required large down payments. Most interest earned on savings deposits was exempt from income taxation (or taxes were evaded easily), while interest on consumer loans could not be deducted from taxable income.

Likewise, government spending on sewers, parks, and streets to improve the quality of life lagged behind expenditures for ports, railways, or electrical plants designed to make the country more competitive internationally.

Citizens, although often complaining of the lack of affordable housing, did little to oppose the government bias toward business. Few sought to change government policy as long as real standards of living were rising and they could gradually acquire consumer status symbols, such as the "three C's": a car, air conditioner, and color television set. (A "fourth C," personal computer, was added in the 1980s.) And most received considerable satisfaction just from reading of the competitiveness of Japanese products abroad and seeing the rising profile of Japan at events such as summit conferences where the Japanese Prime Minister could be photographed standing in the middle of the heads of state next to the American President instead of at the fringes beyond Canada and France.

Defense. Another element in the ability of the government to devote attention to economic growth has been Japan's position as a forward link in the U.S. strategic defense system. Being shaded by the U.S. nuclear shield while spending less than 1 percent of GNP on defense (compared with as much as 17 percent on the eve of Pearl Harbor) not only freed resources for commercial activities, but steered the best scientific minds away from military research and development and toward research on commercial products.

Although increased spending on defense now would likely result in higher (not lower) economic growth rates over the medium term, in the past the lower defense burden did allow the central government to reduce taxes and to devote more resources to industrial activities. Currently, however, given Japan's surplus of capital combined with sluggish economic conditions, any future increase in government spending, whether for defense or for domestic programs, would likely stimulate the economy on the demand side while having few negative effects on corporate economic development (unless increased expenditures were all spent abroad for new equipment). The idea that growth rates would slacken if Japan were to shoulder more of its own defense burden is "simplistic at best and inaccurate at worst." 10/ Still it is apparent that the country did benefit greatly from its relatively low defense spending during the 1960s and into the 1970s when capital was relatively scarce.

2. Microeconomic Policies

Import Substituting Industrialization. The second level at which the government intervened to transform the economy was at the firm or business level. The strategy used by Japan can perhaps best be described as that of import-substituting/export-promoting industrialization. This is economic jargon for the process by which production by domestic industries is developed in order to substitute for purchases of imports. As production rises, exports are encouraged.

This process was first observed and characterized during the 1930s in Japan in terms of Western textiles, looms, and other machinery. The French Jacquard loom, for example, was first imported. As imports rose, domestic production -- encouraged by the government -- began to develop. Japanese altered the looms to fit a country where labor was cheaper and metal parts more expensive. Soon imports declined, and within just a few decades, Toyoda looms were being exported back to Europe.

The success of this development strategy depended on (1) having a domestic labor force and entrepreneurs who could build industries able to compete not only in domestic but foreign markets; (2) enlightened government decisionmakers who could not only decide which industries to foster but could tell when attempts to nurture a domestic industry were futile and could muster the political support to disband infant industry programs; (3) being internationally "invisible" in order to avoid pressures by trading partners to liberalize markets and accept imports; (4) having a citizenry willing to tolerate a lack of consumer goods or public amenities in order that resources could be devoted to industrial development; and (5) a system of education, public health, and social mores that produced workers who were highly motivated, disciplined, technologically literate, and mobile.

The basic philosophy undergirding an import-substituting industrial strategy is that comparative advantage in almost any industry can be created. Even for resource-intensive industries, such as mining and minerals, a country might not be internationally competitive in primary production (because of lack of natural resources) but it can be so in the secondary stages of production. The vital ingredients to create competitive industries are to be found in human and financial resources, and not just in a country's natural endowment.

10/ Okimoto, Daniel I. The Economics of National Defense. In Japan's Economy, Coping with Change in the International Environment, ed. by Daniel I. Okimoto. Boulder, CO, Westview Press, 1982. p. 250-62.

The basic objective of an import-substituting/export-promoting industrial strategy is for domestic production to move as far down the production process as possible in each product. In making copper wire, for example, even though Japan could not be competitive in copper mining, it could be competitive in smelting -- particularly after inventing the continuous smelting process -- and in the manufacture and marketing of copper wire. In most cases, the greatest value added was not in the original mining process anyway but in later stages of production.

For Japan, the import-substitution strategy has worked in many industries, although notable failures also exist. In industrial products such as computers, semiconductors, consumer electronics, machine tools, automobiles, and ships the strategy has worked well. It has worked less well in pharmaceuticals, fertilizers, and aluminum. Essentially, it has failed in beef raising, certain citrus production, and production of some alcoholic beverages. The jury is still out on satellites, aircraft, and biotechnology products.

As the Japanese economy has matured, the import-substitution/export-promoting strategy has been augmented by a policy to phase out declining industries. The shipbuilding, textile, fertilizer, and aluminum industries in Japan have reached their zenith and have required government assistance in reducing capacity and retraining workers. 11/

Strategic Method. As the country has developed, the strategic method has not been "to pick winners and losers" as much as it has been to keep the economy moving up the technological ladder. The ultimate goal has been to develop competitive industries across the economic spectrum, but the sequence in which industries were promoted required a focus on those industries that would form the basis for the next generation of Japanese exports. The industries selected centered on those with high world income elasticity (products whose sales would increase relatively fast as world income rose) and those which embodied sophisticated technology but which promised declining costs of production as output increased. 12/

During most of the high-growth period, the selection was simple because Japan was being pulled up the technological ladder by the need to catch up with world-class industries in the United States and Europe. The targets were clearly visible, and the goal was to narrow the gap between existing technology in Japan and the world's best. now that many industries have caught up with world competition,

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11/ McGregor, Margaret A. and Katherine V. Schinasi. Positive Adjustment Policies Toward Declining Industries in Japan. In U.S. Congress. Joint Economic Committee. Japan's Economy and Trade with the United States. Joint Committee Print, 99th Cong., 1st Sess. Washington, U.S. Govt. Print. Off., 1986. p. 168-180.

12/ Allen, George C. The Japanese Economy. New York, St. Martin's Press, 1981. p. 87-88.

however, the economy is being pushed, as well as being pulled, up the technological ladder.

A former vice-minister of MITI described the pushing forces in this process as follows. Japan is like a large, multi-storied building situated on a seashore. The lowest stories are inhabited by the most labor-intensive producers, such as textile and toy manufacturers. As one climbs up the building, the industries represent higher and higher levels of technology until one arrives at those at the top, such as aerospace, computer systems, and biotechnology. Ocean waves beating on the building represent competition from low-wage, developing countries. Gradually the waves erode away the lower floors. Unless businesses continue to move up to higher floors, their main products will be washed out to sea by LDC competition.

Japan remains highly vulnerable to competition from the newly industrializing countries of Asia because of its rising costs of production, geographical proximity and similarities in culture. While average hourly compensation for production workers in Japan reached $9 in 1986 (at an exchange rate of 170 yen per dollar), such compensation in Korea, Taiwan, and Hong Kong was still less than $2 per hour. 13/ Eventually large segments of labor-intensive production may have to move out of Japan to other Asian developing nations.

Targets. The strategy of the government in inducing movement up to higher levels of technology can be seen in the sequence of industries targeted for development. In the 1950s, Japan's most competitive exports were labor-intensive textiles and light manufactures. At that time, the industries targeted by the government for growth were steel, shipbuilding, chemical fertilizers, synthetic fibers, and some electronics and motor vehicles. By the 1960s, as these favored industries began to make their mark on world markets and increasingly became able to compete on their own, the list shifted toward new branches of engineering, passenger cars, electronics, and petrochemicals.

By the 1970s, the list had moved toward higher technology industries, such as energy, computers, and microelectronics. And by the 1980s, biotechnology, new materials, and artificial intelligence had been added to the list. The targets in 1985 include fewer industries already existing elsewhere (such as aerospace) and more specific products at the frontiers of technology that other nations also are racing to develop.

Means. Japan's industrial policies have not required massive government projects similar to the Anglo-French Concorde supersonic transport or even a government-owned Volkswagen automobile company. In general, since the turn of the century, governmental support for industry has been more incremental and subtle than discrete and overt. Rather than launching high-profile projects with sizable government subsidies, the modus operandi has been to induce firms to compete internationally through a variety of means.

13/ U.S. Bureau of Labor Statistics. Unpublished data.

That is not to say that in recent high technology projects government support has not been highly visible. In the development of products, such as very large-scale integrated circuits and numerically controlled machine tools, the government has provided subsidies, sponsored joint research and development efforts, and has sent signals to private capital markets that such endeavors should be viewed favorably. The Japanese strategy, however, has been to support and encourage companies to collaborate in the R&D phase, but to allow them to compete to the death to commercialize and sell the resultant products.

The more important government support, however, has occurred largely behind the scenes and has been embodied in a myriad of decisions on items such as import tariffs, quotas, foreign exchange licensing, joint ventures, product standards approvals, approvals for direct investments, and financing.

In each case, the underlying philosophy for government officials seemed to have been that domestic products were preferred over foreign and that if domestic products were not available, their development should be fostered. These attitudes carried over to the extent that even activities such as beef and peanut production (that could scarcely be competitive world wide) have been fostered. A recent case illustrates these attitudes. The government forced the Perrier company to manufacture its natural spring water in Japan by requiring that the water from France be sterilized by boiling before allowing it to pass through customs.

In addition to the obvious protection of "infant industries" that is also practiced in many other countries, the government has intervened in other aspects of the economy to favor of its home producers. For example, it might have required that an international joint venture include the transfer of technology to the Japanese partner. Even a wholly owned subsidiary (such as IBM Japan) often was allowed to operate only if it transferred some of its proprietary technology to domestic companies.

Another example was a Japanese chemical firm that was not allowed to import certain equipment with processing tanks that were considered to be too small to provide scale economies that would enable it to become internationally competitive. For many years, foreign exchange applications to import luxury consumer goods, such as automobiles, were routinely disapproved. As long as the government controlled foreign transactions, it held key levers by which it could intervene in private decisions in order to foster the long-term development of the domestic economy. 14/

Competition. This industrial policy did not imply, however, that Japanese infant industries could expect to continue to be

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14/ For further information see: Johnson, Chalmers. MITI and the Japanese Miracle. Stanford, Stanford University Press, 1982. Wheeler, Jimmy W., et.al. Japanese Industrial Development Policies in the 1980's. New York, Hudson Institute, 1982.

nurtured in a protected environment forever. Eventually, industries had to face international competition. The 1985 Action Program, in fact, attempts to establish the philosophy of "freedom in principle, restrictions only as exceptions," 15/ meaning that in principle imports would be allowed with some restrictions on a case-by-case basis, instead of the existing policy that in principle imports would be restricted with some allowed on a case-by-case basis. Whether this principle will be implemented or not, however, remains an open question.

Even during the time industries were protected from external competition they faced formidable competition from other firms within Japan. In the early 1950s, for example, when black and white television sets were being developed, 35 different Japanese firms with an eye toward television production imported the technology from abroad. 16/ There now are 9 major Japanese automakers, 15 makers of videocassette recorders, and 11 mainframe computer makers (including 5 affiliates of American manufacturers) all battling for market share in a crowded domestic market. From early in the industrial policymaking process, planners could see that unless firms were forced to hone their production and marketing skills in competitive markets at home, they would be unlikely to succeed in such markets overseas.

Hence, even though industries might have developed behind protective walls, within those walls were competitive brawls. This meant that firms had to go beyond developing "hothouse industries," anemic from being overly protected and too dependent on the government. In fact, the bulk of the industrial and technological development within Japan has occurred within Japanese firms using primarily their own funds. The government played a supportive role, but the actual performance of the companies can be attributed mostly to their own actions, not the government's. Aggressive growth strategies, a bias toward rapid technological change, stringent quality control, and ruthless exploitation of competitive advantage have provided the basic ingredients of success for Japan's corporations. 17/

On the other hand, government-owned and supported companies, such as the Japan National Railways or Japan Tobacco and Salt Monopoly, have not been particularly stellar performers. The National Railways, despite impressive performance in developing high-speed trains, has been a chronic money loser. And the tobacco monopoly apparently can compete with American and European cigarettes only behind a wall of protection and by bureaucratic maneuvering (such as registering the brand names of potential imported cigarettes under its own name).

15/ Japan Announces Action Program. Japan Report, vol. 31, July/Aug. 1985. p. 1.

16/ Moritani, Masanori. Japanese Technology. Tokyo, The Simul Press, Inc., 1982. p. 121.

17/ Abegglen, James C. and George Stalk, Jr. Kaisha, The Japanese Corporation. New York, Basic Books, 1985. p. 30-34.

Education. Even the country's educational establishment seems designed to support industrial exporters. Although the system has been criticized for its heavy reliance on conformity, rote memorization, and examinations, the competitive nature of the experience forces students to discipline themselves and work exceptionally hard. By the time a Japanese student finishes high school, he is expected to be literate, highly numerate, to have studied a foreign language, to be familiar with the basic sciences, and to have faced the rigors of cramming for what is termed the "examination hell."

In 1955, only about half of the country's eligible youth entered high school. By the late 1970s, this had risen to more than 90 percent, and virtually everyone who entered high school completed it. 18/ Nearly 40 percent of the graduates go on to college.

Currently, educational leaders are attempting to improve the system to allow more emphasis on creativity and innovation, but there is little doubt that the high levels of competition, strict discipline, teamwork, and learning the "basics" have produced legions of factory workers and blue-suited "salary men" who not only can implement techniques such as statistical quality control but who can be trained to represent companies well in international markets.

III. LESSONS FOR INDUSTRIALIZING COUNTRIES

Japan's experience with industrial policy both at a macro- and microeconomic level holds both promise and probable disappointment for currently industrializing countries.

As the first non-European country to scale the industrial ladder, Japan stands as a model for other Asian, African, and Latin American nations. It has demonstrated that such industrialization is possible even without abundant natural resources and with formidable barriers in terms of language, culture, and lack of space.

A. Favorable Conditions

Japan, however, enjoyed several advantages which current industrializing nations do not necessarily have. First was the long period over which the country accomplished its industrialization. Japan embarked on the path toward modernization more than a century ago. And reconstructing its economy after World War II was much simpler than the task confronting newly industrializing nations of creating industries never before existent domestically. The start from "square one" in Japan occurred in the late 1800s not too long after the industrial revolution in the West. In many LDCs today, "square one" occurred after the demise of colonialism following World War II.

18/ Vogel, Ezra F. Japan as Number One, Lessons for America. Cambridge, MA., Harvard University Press, 1979. p. 161.

Japan's second advantage was its near anonymity. Preoccupied by events in Korea, China, Europe, Southeast Asia and at home, Americans and Europeans largely looked the other way when Japan pursued protectionist import policies. Even after being accepted as members of the General Agreement on Tariffs and Trade and International Monetary Fund, other industrialized nations tolerated even the more egregious of Japan's protectionist policies (such as agricultural import quotas). The country was forced, however, to bring its system more into line with the requirements of these organizations by dropping direct subsidies for exports.

Many newly industrializing nations today do not have the luxury Japan had of being invisible. Because of Japan's economic record, countries such as South Korea and Taiwan are being referred to as the "new Japans," and their economic policies are being scrutinized to insure that they will not be able to pursue policies harmful to Western economic interests without objections being lodged.

Japan's third advantage was that it was able to wrest proprietary technology from leading international firms who little suspected that the same technology would return in the form of competing products in years to come. World-class companies often jumped at the chance to license technology, particularly that which either was not at the cutting edge or so far out front that commercial applications did not yet exist. And even if some firms did refuse to license certain technology, a competing firm could usually be found that would do so. In the 1960s, Japan imported 7,295 foreign technologies, of which 57 percent or 4,144 came from the United States, 19/ many of them for nominal amounts considering the cost of developing them domestically.

Now, however, leading firms are more wary of transferring technology without some return other than just current cash. Technology exchanges are becoming more mutual and long term, with consortia of multinationals sharing new developments and covering world markets jointly. 20/ Japanese companies with little technology of their own to offer, will find it more and more difficult to license advanced technology from world-leading firms. And leading firms are just as likely to establish subsidiaries to take advantage of new growing markets rather than transfer their technology to potential competitors.

The fourth advantage Japan enjoyed was that it embarked on its income-doubling plan during the 1960s at a time when world economies were embarked on the longest period of sustained economic growth in modern economic history. Recessions that did occur were often called "growth recessions," which indicated that the growth rate merely slowed down. The uninterrupted economic expansion combined with liberalizing

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19/ Ozawa, Terutomo. Japan's Technological Challenge to the West, 1950-1974: Motivation and Accomplishment. Cambridge, MA, The MIT Press, 1974. p. 25-7. Woronoff, Jon. Technology Transfer...Asian Style. The Oriental Economist, vol. 52, March 1984. p. 26-29.

20/ Ohmae, Kenichi. Triad Power, the Coming Shape of Global Competition. New York, The Free Press, 1985.

world trade and a U.S. preoccupation with the war in Vietnam provided enormous opportunities for Japan's exporters.

Japan's fifth advantage was its low requirements for national defense. Unlike South Korea, Taiwan, China, and other industrializing nations, there has been no need for heavy military spending or conscription. The U.S. nuclear shield combined with the widespread perception that the most likely and persistent threat to national security would arise from international economic problems (such as an oil embargo, soybean shortage, or balance of payments crises) rather than a foreign invasion or nuclear war allowed the best resources to gravitate toward commercial, not military, activities.

B. Some Lessons for LDCs

Despite the unusually favorable conditions under which Japan developed its industrial strength, the Japanese experience still can be useful for current less developed countries. Many of the problems now being faced by LDCs were also faced by Japan in the not too distant past. Shortages of foreign exchange, a scarcity of finance capital, technological backwardness, the difficulty of transferring resources from low productivity jobs in services and the agricultural sector to higher productivity jobs in manufacturing, a paucity of businesses with expertise in international languages and culture -- all were obstacles that Japan has overcome to one extent or another.

Current LDCs, moreover, can improve on the methods used by Japan. Japan, for example, relied primarily on the bureaucrats in the ministries of Finance and International Trade and Industry to balance foreign exchange accounts without devaluing their currency. Modern LDCs who do not necessarily have the lean and well-respected bureaucrats who can accomplish this task can place some of the responsibility on importing companies, particularly, foreign multinationals to do so. Despite protests from other countries, China and Mexico increasingly are resorting to performance requirements -- requiring, for example, that foreign subsidiaries or joint ventures balance their foreign trade accounts. That is, for company imports to be balanced by exports, thereby bypassing the need for difficult day-to-day decisions by bureaucrats.

Capital. Japan's approach to generate finance capital both internally and externally was to rely on international borrowing only for emergencies and to provide incentives for domestic savers not to consume. These incentives included the tax free status of savings accounts (to a certain level), high rates of interest on loans for consumption, the practice of paying up to a third of a worker's wages as large, semiannual bonuses (which facilitated household saving), and an inadequate system for mortgages, pensions, and tuition subsidies (which encouraged private saving for these purposes). The resultant high personal savings were augmented by a banking system, backed by the

Bank of Japan, that permitted the practice of "overloaning" in which banks loaned more than their reserves could justify. 21/

Technology. Japan overcame its technological backwardness by a combination of importing from abroad and fostering technological development domestically. Technology was imported through licensing, "reverse engineering," and a systematic scouring of the world for inventions and innovations.

Technology was developed domestically by first building on known products. Over most of the postwar period, Japan's contribution to modern technology has been mostly in incremental improvements to existing products and in process technology. Major technical contributions from Japan have been a relatively recent phenomenon. From 1953 to 1973, of 500 significant technological innovations, only 34 came from Japan. 22/

Examples of Japanese improvements to technology, however, abound. Sony, for instance, did not invent the tape recorder, but it miniaturized the unit and created a whole new market for portable, personal recorders. It also designed a production system that combined automation, inventory control, and quality assurance which gave it low production costs and high quality. Only after such experience with improving existing technology, did Sony succeed in projects such as commercializing the video cassette recorder and developing a compact disc player.

Agriculture. Japan's support of the growing industrial sector by the agricultural sector also is instructive. In the country's early industrialization, exports of silk and tea paid for imports of modern equipment and technology. Surplus savings from agriculture were transferred to industries often through landlords who had one foot in each sector. From early on, a rational system of government taxation based on agricultural production was able to finance government expenditures.

As the economy was being transformed, the agricultural sector provided the labor needed in the growing industrial sector. The country gained as people in low-productivity jobs were transferred to higher-productivity jobs in urban factories. As a result, the population gradually become urbanized. In 1960, 29 percent of Japan's jobs were in agriculture and forestry. By 1970, this percentage had fallen to 17 percent, and by 1980 to 10 percent. 23/

Despite the decline in the importance of agriculture in the total job spectrum in Japan, farming (along with small-scale retailing),

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21/ Adams, T.F.M. and Iwao Hoshii. A Financial History of the New Japan. Palo Alto, Kodansha International, 1972. p. 36, 65, 534.

22/ Moritani, M., Japanese Technology, p. 18-19.

23/ Japan. Management and Coordination Agency. Japan Statistical Yearbook, 1984. Tokyo, Ministry of Finance Printing Bureau, 1984. p. 72-73.

still serves as the employer of last resort and hides a considerable amount of underemployment in Japanese society.

When the government has intervened in the urbanization process, it generally has done so to slow rather than to hasten the demise of the small farmer (as well as mom-and-pop retail store). Examples include current land tenure laws that inhibit absentee ownership, protection from food imports, high agricultural subsidies, as well as property taxes that encourage owners to keep land in agricultural production despite its extraordinary value in industrial or residential use (and restrictions on building supermarkets). These have slowed the consolidation of farms or elimination of the small, part-time farmers in suburban areas.

The Japanese logic here is that for certain industries, adjustment to international competition is too difficult to allow international markets to determine survival. Many of the persons employed in agriculture (and retailing) are the elderly or persons not well suited to assembly line work. Some inefficiency and low productivity, therefore, is allowed in exchange for having an employer of last resort and keeping the government unemployment rolls down. (The inefficient distribution system, moreover, tends to keep out imported consumer goods.) A question, however, is how much longer the Japanese consumer will be willing to pay the price for such inefficiency.

Foreign Language Competency. The Japanese solved their problem of a lack of personnel competent in foreign language and culture by establishing trading companies that specialized in buying and selling both domestically and on foreign markets. These firms provided the international expertise to Japanese conglomerates. The government also established the Japan External Trade Organization (JETRO) and other institutions to provide overhead and technical support for exporting companies. [24] The Japanese education system, furthermore, required years of foreign language study, while individuals targeted to work in international divisions of companies often spent long periods of time abroad.

IV. PROSPECTS FOR THE YEAR 2000

Japanese speak of a twenty-year cycle in the fortunes of their country. There are twenty years of prosperity followed by twenty years of turmoil. The 1920s and 30s generally were prosperous but were followed by the war, occupation, and reconstruction of the 40s and 50s. The 60s and 70s were prosperous but many fear that the 80s and 90s will hold new and difficult challenges for the country.

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[24] U.S. Library of Congress. Congressional Research Service. JETRO: The Japan External Trade Organization. Report No. 85-1112 E, by R. Kevin Flaherty. Washington, 1985.

A. A New Uncertain Age

Today Japan is at a major turning point in its economic history. Although currently riding the crest of a wave of success, and despite an optimistic forecast by its Economic Planning Agency in 1985 that the country was entering a new age of economic growth without inflation, the country has found that the conditions that have supported its rapid economic growth have now changed. [25]

Just as 1954 marked the end of the postwar reconstruction, and 1973 the beginning of supply limitations, the mid-1980s mark the entry into a new and more uncertain era that seems to require a complete rethinking of Japan's growth formula. Actually, the nation merely faces conditions that are similar to those already confronted by other advanced nations. They are caused by protectionism abroad, the internationalization of the economy, and the diminished ability of government to direct economic activities.

Protectionism. The first and most important characteristic of this new age is the rising swell of protectionism aimed at Japan's exports. In the past, the country could exploit market niches, or as the Japanese say, "glean rice from the fields." Exports could slip into markets -- usually at the low end -- without drawing much attention. Admittedly, disputes over Japan's exports of textiles, steel, and television receivers flared up periodically, but these conflicts could be managed by stretching out negotiations and establishing a relatively large Japanese market share either through quotas or voluntary restraints. [26]

Japan's exports now have grown so large, however, that even in massive markets like the American or European, they stand out and are accused of causing disruptions. A wide spectrum of established industries in the world has been or is currently being threatened by competition from Japan, and a loose coalition of interests is willing to support measures to prevent further Japanese incursions into home or foreign markets.

Europe is a case in point. A burgeoning trade deficit with Japan along with rising market shares for Japanese cars and other products is stirring protectionist sentiments not unlike those already alive in the United States and Asia. While Japan heretofore has been able to circumvent major difficulties by stopgap measures, such as voluntary export restraints, establishing assembly plants in European countries, and playing one country off against another (particulary in bidding for the location of Japanese assembly plants), both the European Community and individual member nations are taking a serious look at what they term to be the "Japan problem." If the hard-liners prevail, Japan may find that increased exports to Europe will be very difficult without a similar increase in imports from Europe into its own market. 27/

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[25] Nanto, Dick K. Japan's Economy. Current History, vol. 84, December 1985. p. 415-16.

[26] Destler, I.M. and Hideo Sato. Coping with U.S.-Japanese Economic Conflicts. Lexington, MA, Lexington Books, 1982.

Internationalism. The second major characteristic of the new age is the growing internationalization of Japan's domestic economy and the resultant economic interdependence. Given the country's large role in international trade, plus the rapid reduction in official import barriers in its product and capital markets, economic activities in Japan are being influenced more and more by activities abroad. Japan can no longer adopt macro- or microeconomic policies without considering their impact on other countries. The economic policies of other countries, moreover, particularly those of the United States, not only affect Japan but place a constraint on domestic policies.

Japan, for example, is no longer immune to the effects of world business cycles. A recession in other major industrialized countries is likely to drag the Japanese economy down also. The internationalization of the yen, moreover, is forcing Japan's financial markets to respond to world markets and is diminishing the ability of monetary authorities to control domestic interest rates. The decontrol of financial markets is rapidly turning Tokyo into an international financial center similar to those in London and New York. 28/ And Japan's legislative process is increasingly being monitored by other nations to insure that policies are not adopted that would be unfavorable to outside interests.

Japanese corporations, moreover, increasingly are being forced to adopt practices similar to those in other nations. The foundation of Japanese management includes permanent employment, seniority-based promotions, a wholistic concern for the employee, early retirement, male-based management, and other paternalistic practices. These are being challenged by pressures generated by the slower rate of growth, financial realities, and the more international staff of companies that are rapidly becoming multinational.

Role of Government. The third characteristic of the new age is the diminished role of government and its influence over the private sector. The popular interpretation of Japan's economic development has been that much of its success can be attributed to the skillful work of Japan, Inc., the triad of business leaders, bureaucrats, and politicians who guided the economy to world-class status.

There is no doubt that the government worked hand in hand with business in fostering modern economic development in Japan. Historically, the ministries attracted Japan's brightest new college graduates, and the central government had the authority to set the national economic agenda, to intervene in private economic decisions

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27/ Information from interviews by the author with government officials and members of parliaments of the European Community and France, Germany, and the United Kingdom during May and June, 1986.

28/ Sakakibara, Eisuke and Akira Kondoh. Study on the Internationalization of Tokyo's Money Markets. JCIF Policy Study Series, No. 1. Tokyo, Japan Center for International Finance, 1984.

(through administrative guidance), and to veto undesirable dealings with foreigners.

During most of the postwar period, moreover, a national consensus prevailed that the top priority was to catch up with the advanced industrial countries of the world. Domestic industries were to be strengthened to compete internationally. Domestic infant industries were favored, even if Japanese consumers had to put up with high prices and low quality during the initial years. Social infrastructure took second priority to industrial development.

By the mid-1980s, however, the power of the ministries had eroded. Given the decontrol of foreign exchange and capital transactions, with businesses no longer dependent on the government for loans or loan guarantees, with no consensus on national priorities, and with private firms obtaining access to their own foreign information and technology, the power of government to intervene has diminished.

The Japanese bureaucracy is still relatively paternalistic with respect to industries under its jurisdiction, but much less so than in decades past. With less intervention, the Ministry of International Trade and Industry is rapidly assuming a role more like a think tank that can analyze trends and give advice on strategy rather than controlling the day-to-day activities of businesses under its jurisdiction. 29/ Japanese industrial policy now tends to focus on the two ends of the product cycle -- at the launch and at the decline of an industry -- the times in any life cycle when outside help is the most necessary.

The government's budget deficit, moreover, has become a major constraint on policy. Given a 1985 deficit of $49 billion or 22 percent of expenditures, along with projections of rapidly escalating outlays for interest on past bond issues, government policy is increasingly shifting toward allocating scarce funds rather than dividing up rapidly expanding revenue windfalls (as was the case in decades past). The only two budget categories that have been growing consistently are defense and foreign aid, primarily because of external pressures. New programs to fund research and development, build new infrastructure, or provide subsidies to industries face increasing competition from other budgetary categories. The reduced flexibility in the budget has diminished the ability of bureaucrats to control businesses by influencing budget decisions.

Aging. Japan's future, moreover, is clouded somewhat by the rapid aging of its population and the consequent effect of this change on rates of saving and government expenditures. By the year 2000, the percentage of Japanese over 65 years old is expected to rise from the current 10 percent to around 16 percent, the same level as that of Sweden in 1980. 30/

29/ Interviews by the author with MITI officials and business executives in Japan during 1983 and 1985.

30/ Japan Economic Planning Agency. Japan in the Year 2000. Tokyo, Japan Times, 1983. p. 117-147.

When tax revenues were rising rapidly during the years of high inflation in 1972 and 1973, Japan's aged were given virtually free medical care along with a hefty increase in social security pensions. As society ages, these expenditures will become a larger and larger burden on the central government's budget. Savings rates, moreover, are likely to fall, as relatively fewer people will be in the economically active population and the elderly use their accumulated savings for consumption.

The aging of society also affects productivity and the costs of manufacturing. Japanese plants have been able to keep costs down by expanding rapidly and hiring young (and cheap) workers. As growth slows and the labor force grows older, however, the average age of a worker will increase, and wage (and retirement) costs will rise.

Despite the aging problem, however, the population is expected to continue to save and invest at rates sufficiently high to maintain growth rates. Even if current personal savings rates (17 percent of disposable income) and investment rates (28 percent of GNP) decline, they would still be relatively high for an advanced industrial country.

B. Maekawa Report

In April 1986, a blue ribbon advisory group appointed by Prime Minister Nakasone reported that "the time had come for Japan to work a historical transformation of its traditional economic policies and pattern of life." It recommended that the government set a medium-term national policy goal of steadily reducing the nation's trade imbalance to the extent harmonious with the world economy. It also recommended that Japan turn from excessive dependence on exports to expanding domestic demand and improving the quality of life of the people.

Specific recommendations in the report included promoting housing policies and urban redevelopment, reducing working hours, promoting social infrastructure, encouraging adjustments from declining to rising sectors, promoting direct investments both overseas and at home, encouraging imports of manufactured goods, liberalizing financial and capital markets, and promoting increased economic assistance to developing nations. 31/

The advisory group concluded that the country must recognize that continued large trade imbalances create a critical situation not only for the management of the domestic economy but also for the world. Without changes in policies, there could be little further development for Japan.

31/ The Report of the Advisory Group on Economic Structural Adjustment for International Harmony. Submitted to the Prime Minister, Mr. Yasuhiro Nakasone on April 7, 1986. (Provisional translation). Tokyo. Photostatic copy.

The recommendations of the report are consistent with the new era of uncertainty for Japan. The nation no longer can exert the type of control over domestic markets once taken for granted. The swell of protectionism aimed at it from abroad, moreover, is receiving the highest consideration among the country's policymakers.

The time has come, furthermore, when citizens are seeking to enjoy more of the fruits of their labor. Young aspiring managers are asking why they should work so hard to acquire status symbols of consumption without the time or space to enjoy them. And even though most Japanese were offended at the characterization of their housing as "rabbit hutches," such foreign criticism of their lifestyle has caused them to consider whether or not their single-minded pursuit of world market share for their manufactured products has caused an imbalance in the development of their society. And business leaders, who once thought Western criticism of their export success was simply a form of sour grapes, now realize that bilateral trade surpluses with the United States, Europe, and countries of Asia, while in theory perhaps not economic problems, certainly had become political ones. 32/ Hence, the need for the Maekawa study.

The question, of course, is whether or not the government can reign in its aggressive exporters and shift their focus of economic activity from foreign to domestic markets. And even if the government should succeed in doing so, a question remains as to whether or not such action would make any appreciable difference.

Given that the locus of business strategy and activity has now passed from government to private hands, the ability of the government to change the behavior of businesses seems limited. In particular, since the export successes of Japanese firms were not provided by the government in the first place, it would be extremely difficult to take those successes away. The government should be able to make some incremental changes in policy -- shifting more subsidies into consumer goods, such as housing -- but it can hardly ask its businesses to become less competitive in world markets.

Japanese exporters, moreover, often see other Japanese companies as their major competitors in overseas markets and not the foreign producers. For many products, the perception is that if one can win a market share against other Japanese competitors, the non-Japanese competition will be taken care of in the process. In the U.S. and European motorcycle markets, for example, it appears that Honda was less concerned about competition from Harley Davidson or Triumph than it was from Kawasaki and Suzuki. In the rough and tumble battle for market share among the Japanese producers, Harley Davidson and Triumph were nearly wiped out.

Another problem is that the growing popularity of voluntary restraints as a solution to trade friction has created a rush among

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32/ U.S. Library of Congress. Congressional Research Service. Japan-United States Economic Relations: Views of Japan's Economic Decisionmakers. Report No. 86-52 E, by Dick K. Nanto. Washington, 1986. p. 33-34.

Japanese exporters to establish market share in foreign markets early in the product cycle. If not, if export restraints are imposed and the export market divided according to historical market shares (as is the usual practice), the latecomers will be penalized. Witness the predicament of Isuzu, Suzuki, Mitsubishi, and Subaru who were stuck with small allocations of cars bound for the lucrative American market because they were selling fewer cars than Toyota or Nissan when the voluntary restraints were announced.

Hence, when one company finds a potential export market, others quickly follow. The result is a surging market share for all Japanese producers and what appears to the host country as a laser-beam incision into domestic markets. For the Japanese government, however, other than trying to persuade exporters to be prudent or, in the extreme case, to impose voluntary export restraints or price floors, there is little it can do to control such competitive behavior. Such ruthless exploitation of competitive advantage has become ingrained in Japanese business strategies and is unlikely to disappear in the near future.

For the Japanese government, therefore, changing the orientation of Japanese exporters from foreign to domestic markets appears futile. Actually, Japanese exporters already are competing heavily in domestic markets. In fact some companies, such as Honda, have sought refuge in foreign markets to escape some of the cutthroat competition at home.

Quality of life. What the government can do, and what seems to be implied in the Maekawa recommendations, however, is to change its policies from being driven by the import-substitution/export- promotion formula to one that places a high priority on the quality of life. Such a perspective for government policy would favor high domestic growth; less government intervention; more funds for housing, sewers, parks, and other social infrastructure; liberalized imports; and greater economic freedom for all in society.

While this might not result in less trade friction abroad, at least the country could not be accused of basing its exports on sweatshop labor living in rabbit warrens surrounded by a society totally regimented toward building a better semiconductor.

And if these changes are not made, the foreign exchange market probably will, over time, restore equilibrium to the trading system anyway. In this case, hard-won productivity gains would be offset by an appreciating yen. In the meantime, the image of Japan could continue to erode, and the country could find itself increasingly isolated in world opinion.

The importance of the Maekawa Report is not that it lays out a comprehensive blue print for change, but rather that it marks a turning point in Japan's postwar economic policymaking. For the first time, a government commission has concluded that the import-substituting/export-promoting industrial strategy has reached its limits and that the time has come to shift to a new, domestically oriented policy. As this policy is pursued, more studies will be commissioned, concrete actions will be recommended, and resistance will be formidable, but the turning point in the process will likely be seen as the Maekawa Report.

C. Economic Outlook

Despite the difficulties facing Japan, it still should perform as well as or better than other industrialized nations over the next fifteen years. Barring a major economic, political, or natural disaster, economic growth should average about 3 percent per year in real terms. 33/ This would be at the moderately high end of the spectrum for advanced industrial nations and about the same rate at which the country was growing during the last two decades of the nineteenth century. At this rate, the economy should double in about 24 years (rather than the 7 years it took to double during the 1960s).

Given this growth rate, Japan is unlikely to overtake the United States in terms of the absolute size of its GNP in the near future, although if the yen should appreciate to 100 yen per dollar (from 155 in mid-1986), the dollar value of Japan's GNP at around $3 trillion would approach that of the United States. Japanese per capita income (and wages) then would be nearly twice that of the American.

Japan's surplus on merchandise trade is likely to peak over the next year or so and decline after that. Much will depend on whether the country will continue to provide capital to the world and on the behavior of commodity prices (particularly oil). If Japanese investors do not continue to ship money abroad or begin to call in their capital and sell their overseas portfolio investments, the yen may appreciate so much that the trade surplus could diminish considerably. Japan could find itself in the same situation as Germany -- a country making products of quality but whose prices are high because of a strong currency. Currency appreciation could make Japan a high-cost producer in the world. And the current windfall in the form of lower prices for petroleum and food could reverse itself in the future and increase the country's import requirements.

Regardless of what happens in currency and commodity markets, Japanese companies will continue to be a major force in international trade. Even with a stronger yen, overseas investments and subsidiaries in low-wage countries along with advancements in robotics and flexible manufacturing should allow them to continue to offer competitive products in world markets. In fact, much of any decline in Japan's trade surplus could come from increased overseas production by Japanese companies, themselves.

Japan's overseas direct investments have been motivated by the need to secure stable supplies of raw materials and, more recently, to circumvent protectionist trade barriers. By the late 1980s, for example, Japanese automobile companies are expected to be producing more than one million vehicles per year in the American market. In 1986, as the yen has risen, corporations have been looking toward investing in other nations in order to contain costs of production. In most cases, these investments have been welcomed, although some have

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33/ This is not an econometric forecast but a bench-mark estimate put forth to generate discussion.

been characterized as "Trojan horses" or mere "screwdriver operations" that bring little value to the local economy. Still, given the excess of capital in Japan, the country is likely to remain a major supplier of investment funds and a creditor nation over the next 15 years.

Japanese industry has been hobbled by a government ban on exports of military products. Even dual-use technology is scrutinized carefully. Without the prospect of exporting, little incentive exists for businesses to develop products needed to become competitive in international military markets. As Japan's defense budget rises and growth in other exports slows, however, the government could reconsider its export ban. If so, a vast market could be opened to Japanese producers.

Japanese exporting industries, moreover, currently are riding the crest of a wave of prosperity in which their products are in strong demand the world over and their product pipelines are full. They have established themselves in overseas markets, and during the profitable years of the early 1980s, while the yen was undervalued, improved their balance sheets. Research and development programs are well funded, and products using new technologies are already in the commercialization phase. Many markets, moreover, are far from being saturated with Japanese products.

American businesses, therefore, will continue to confront considerable competition in mass-produced products from Japan (as well as from other Asian Pacific nations). And unless they look beyond the lucrative U.S. market and maintain an Asian strategy, they could find themselves being thrashed about in the jaws of competition and their market shares being eaten away.

This Asian strategy would include: (1) maintaining a presence in Asian markets; (2) monitoring technology and product developments in Asia; (3) continual efforts to lead in product development and to reduce production costs to remain competitive with Asian producers; (4) greater emphasis on maintaining market share and on exporting, particularly to Japan, rather than on generating short-term profits or raising stock prices, and (5) more attention to pricing strategy, product design, packaging, and quality assurance.

Without such an Asian strategy, American businesses competing with Japan and other countries of Asia could find themselves fighting a losing battle in which their only hope for survival would be to circle the wagons and petition the government for protection.

Japanese businesses, however, are not invincible. They too make mistakes and are subject to product cycles. As they confront many of the same problems of other multinational corporations, they are likely to settle into market patterns similar to those of other nations. As strong as Japan's exporting companies are, they are not so dominant that foreign firms cannot compete with them. A fundamental premise of economics is that a nation may have a comparative advantage in many industries, but it cannot dominate them all. And the future points more toward consortia of firms in the major markets jointly developing and marketing products rather than just for firms from one country to be competing against firms from another. 34/

At home, moreover, Japanese businesses are having to alter traditional management practices, such as permanent employment and seniority promotions, as growth in the economy has slowed and new capacity is being built overseas. The unemployment rate is nearing 3 percent and rising, despite the slow growth in population and lack of inward immigration. Japan, therefore, faces problems not unlike those in other nations.

For U.S. government policy, the growing economic strength and integration of the Japanese economy into world markets implies that economic policy deliberations need to include consideration of the Japan effect (or international effect). For example, a decision, such as the one to break up the AT&T telephone monopoly, might have been better had it given more consideration to the effect on imports of telecommunications equipment from Japan and the ability of American telephone companies to compete in world markets. The international effects of monetary or fiscal policies, education policy, science policy, and even domestic transportation policy should also receive due consideration.

In world politics, Japan's standing should continue to rise as it attempts to gain influence commensurate with its economic power. The era when the United States, for example, could begin the process of rapprochement with China without consulting Japan has gone. Japan is likely to take an increasingly independent stance on foreign policy issues, although it probably will continue to look to the United States for guidance, since international political leadership has not been in the Japanese tradition.

In international relations, Japan's dependence on imports of raw materials and food and on export markets has forced the country to walk a thin line that separates politics and economics in order not to offend trading partners. The country even has been reluctant to intervene in disputes in its own region, such as that between the two Koreas or between China and Taiwan, and has not been particularly aggressive in pursuing the return of some northern islands from the Soviet Union.

Still the new generation of Japanese leaders and bureaucrats is likely to chart a more independent course in world affairs. This generation appears to feel less indebted to the United States for postwar assistance, less influenced by traditional industries (such as steel that, in turn, feel indebted to U.S. industry), and less willing to follow political signals from the United States without first considering its own interests.

The most likely external political thrust for Japan would be to seek closer ties with its Asian neighbors in order to create a Pacific market comparable in size to the European or North American -- particularly as the European Economic Community becomes more unified and the

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34/ Ohmae, K., Triad Power.

United States and Canada continue talks on establishing a free trade area. 35/ Its growing foreign aid budget should give it more influence with developing nations in the region. (Japan, however, appears to have more to gain from being included in a U.S.-Canadian free trade area.) It also will have to devote considerable energy toward resolving disputes over its export behavior -- particularly with the United States and Europe.

In summary, the heyday of Japan's high postwar economic growth has ended. It now faces the task of reorienting itself toward becoming a full contributing member of the world community of nations.

35/ Tokuyama, Jiro. "Pacific Economic Community" Concept. The Oriental Economist, vol. 48, July 1980. p. 10-13.

CHAPTER 3

EXPORT-LED DEVELOPMENT: THE EAST ASIAN NICs *

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[*] Prepared by William H. Cooper, Analyst in International Trade and Finance, Economics Division, Congressional Research Service.

I. INTRODUCTION

In discussions of Third World economic development, four countries stand out as "major success stories"-- Hong Kong, Singapore, South Korea, and Taiwan -- the East Asian newly industrializing countries (NICs). Sometimes called the "gang of four," "the four dragons," or the "new Japans," these countries also stand out as increasingly important participants in the international economic system, particularly as the United States, Japan, and Western Europe are concerned. Some analysts have also cited the four East Asian NICs as models for other developing countries to emulate.

This paper reviews and compares the economic development policies and experiences of the four East Asian NICs from 1960 to the present, specifically the role of exports. The paper examines the U.S. role and its policy implications. It concludes with an analysis of the factors that will help determine the economic prospects of the East Asian NICs for the remainder of the 1980s.

The study shows, among other things, that the East Asian NICs have based their economic successes on exporting during the past two decades. The United States has been the most important export market for the NICs, and therefore, a significant factor in their economic growth and development. Economic conditions in the United States and other industrialized countries, access to U.S. export markets, world energy prices, and the political environment within and around the four East Asian NICs will go a long way in determining how well they do for the remainder of the 1980s.

II. BACKGROUND

The four East Asian NICs are among the most successful economies in the developing world. With 1984 per capita Gross National Product (GNP) of $2,000 for South Korea, $3,000 for Taiwan, $6,300 for Hong Kong, and $7,200 for Singapore, they are richer than most developing countries and, in some cases, are closely approaching industrialized countries.[1] Over the last two decades, the NIC economies have grown more rapidly than most developing countries and more rapidly than the industrialized countries. From 1965-83, for example, Hong Kong's per capita GNP increased an average 6.2 percent per year; South Korea's -- 6.7 percent; Singapore's-- 7.8 percent; and Taiwan's -- 8.1. During the same period per capita

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[1] Data for Hong Kong, Korea, and Singapore are from the World Bank. 1986 World Development Report. Washington. 1986. p. 180. Taiwan data are from U.S. Department of Commerce. International Trade Administration. Foreign Economic Trends. Taiwan. November 1984. p. 2.

GNP for the United States, Japan, the Federal Republic of Germany, the United Kingdom, and France together averaged 2.8 percent per year. 2/

The four NICs are making themselves felt in the United States and the rest of the industrialized world as major trade partners and international competitors. Together they bought 8 percent of U.S. exports and supplied 12 percent of U.S. imports in 1985. 3/ Growing shares of these imports are in manufactured goods, such as textiles, steel, and even cars, which compete head-on with U.S. production.

Observers often attribute the economic success of the East Asian NICs to government strategies which have promoted exports as the "engine of growth" for the rest of the economy. An export-led growth strategy encourages industries in which the country has a comparative advantage to produce and compete in the world market. The government maintains exchange rates that reflect the international value of exports and permit exporters to obtain imported raw materials at competitive prices. Sometimes the government offers subsidies, tax benefits, and other incentives to encourage exporting.

Many developing countries have followed an import-substitution strategy. Under import substitution, the government protects domestic producers from foreign competition through complex foreign exchange regulations, import restrictions, high tariffs, and other controls. Under this protection, domestic producers develop the capabilities to supply the domestic market with products that had been imported. Often import-substitution policies are accompanied by overvalued exchange rates, export taxes, and other disincentives to exporting.

A number of economic reasons underlie the apparent superiority of export-led growth over import substitution. 4/ Import substitution requires domestic producers to rely on domestic markets. Yet, in most developing countries, domestic markets are too small to sustain production at economically efficient levels. Under an export-promotion regime, domestic producers can expand production beyond local markets.

In addition, export-led growth allows an economy to concentrate on producing those goods and services in which it has a comparative advantage while importing the others. Developing countries generally are abundant in unskilled and semi-skilled labor and, therefore, possess a comparative advantage in textiles, footwear, and other labor-intensive

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2/ The World Bank. World Development Report 1985. p. 174-175.

3/ U.S. Commerce Department data. TradeNet computerized data retrieval system.

4/ The following reasons are cited by Anne O. Krueger in The Experience and Lessons of Asia's Super Exporters. In Export-Oriented Development Strategies: The Success of Five Newly-Industrializing Countries. Vittorio Corbo, Anne O. Krueger, and Fernando Ossa eds. Westview Special Studies in Social, Political and Economic Development. Boulder, Colorado, Westview Press, 1985. p. 197-200.

industries. Import-substitution based economies try to develop a range of industries, which may lead to a misallocation of resources.

Analysts also cite a "survival of the fittest" argument. Under an export-promotion growth strategy, domestic companies face competition from foreign companies which weeds out the least efficient producers. Import-substitution protects inefficient producers.

Export-led growth has disadvantages. Economies are more vulnerable to the vagaries of the international economy. Governments often grant subsidies and other benefits to exporters which lead to misallocation of resources.

III. ECONOMIC DEVELOPMENT IN THE NICs

A. South Korea

Prior to the 1960s, South Korea exhibited many qualities typical of a developing country: low per capita income, high inflation, an economy based on primary commodities, severe balance of trade deficits, and a heavy reliance on economic aid, particularly from the United States.5/ Many of these problems resulted from the dislocations caused by Japan's occupation and withdrawal from Korea after World War II and from the Korean War. Korea also lacked natural resources but possessed an abundant supply of labor.

In the wake of the Korean War in the mid-1950s, the Seoul government instituted an import-substitution development strategy to break the country's dependence on primary commodities and to develop labor-intensive light industries. Korea managed some economic growth and development, but by the end of the 1950s and the beginning of the 1960s, Korea's economic growth was declining. Furthermore, the United States was reducing economic aid, forcing Korea to find alternative sources of foreign exchange. 6/

The Korean government under President Park laid the foundation for South Korea's export-oriented industrialization drive in the early 1960s. Many elements of this campaign remain in effect.

The key element of the strategy has been a series of incentives to make producing for export more attractive than producing for the domestic market: exemptions from customs duties on imported raw materials for exporters, reductions on tax liabilities on business income derived from exporting, and waiver of import restrictions for exporters. The government also has granted import privileges to exporters who achieve or exceed export-revenue thresholds. To underscore its commitment to export promotion, the Korean Government established, in the mid-1960s, the Korea

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5/ Ibid., p. 191.

6/ Kim, Kwang-Suk. Lessons from South Korea's Experience with Industrialization. In Export-Oriented Development Strategies. The Success of Five Newly-Industrializing Countries. p. 59.

Trade Promotion Corporation (KOTRA), to help market Korean-made products overseas. 7/

The Korean government changed its other economic policies to conform with its export-promotion growth strategy. Beginning in 1961, it implemented a series of won devaluations to improve the price competitiveness of Korean exports. It also discarded the multiple-exchange rate system, a legacy of the import-substitution strategy, and established a unified exchange rate. This change was designed to reduce the confusion a multiple-exchange rate system generates, which itself impedes exporting.8/ With some exceptions, the Korean government has tried to maintain realistic exchange rates since this period. The government has also given preferential treatment to exporters in rationing credits. 9/

Since the early 1960s, the Korean Government has been liberalizing its import policies to permit exporters to obtain imported inputs at competitive prices. For example, in 1967, it shifted from a positive-list system for imports (that is, a list which indicates only those products which can be imported) to a negative (list of products which cannot be imported). Some observers view this change as a step towards liberalizing import policy. 10/ Korea does not follow a free-trade policy, however. It still protects domestic industries from foreign competition. The government restricts imports of computers, construction equipment, sporting goods, and agricultural equipment through import licensing and high tariffs.

Since the 1960s the Korean government has taken steps to attract foreign investment. In 1960 it passed the Foreign Capital Inducement Law to establish foreign participation in specific investment projects. The government later loosened restrictions on foreign investment, such as minimum requirements for Korean equity participation, and established foreign investment incentives, including tax holidays for foreign investors. 11/ But Korea restricts foreign participation in certain sectors, such as tobacco and insurance to protect domestic "infant" industries from foreign competition.

7/ Krueger. The Developmental Role of the Foreign Sector and Aid. p. 95-96.

8/ Ibid., p. 86-89. See also Kwack, Sung Yeung. Economic Development in South Korea. In Models of Development: A Comparative Study of Economic Growth in South Korea and Taiwan. Lawrence J. Lau (ed.) Institute for Contemporary Studies. San Francisco, ICS Press, 1986. p. 90-92.

9/ Ibid., p. 98.

10/ Ibid., p. 127.

11/ Ibid., p. 143.

TABLE 1. Major Economic Indicators -- Korea
(Average annual growth rates)

	1961-65	66-70	71-75	76-80	81	82	83	84	85
Real GDP	6.5	12.7	9.0	7.6	6.9	5.5	9.5	7.9	4.7
Real Exports	N/A	33.1	33.6	15.9	17.5	6.5	16.3	15.6	7.6
Real Imports	N/A	35.0	11.4	15.6	11.1	0.3	13.3	15.6	6.1

Source: CRS calculations based on data from the International Monetary Fund. International Financial Statistics. TradeNet Computerized data retrieval system.

Since the early 1960s, the Korean economy has achieved substantial growth, and exports have been a major factor. The role of exports in total production has increased. In 1962, exports accounted for 5.1 percent of total Korean Gross Domestic Product (GDP) and 37.5 percent in 1984. 12/ The data in table 1 indicate that overall Korean economic growth (as measured by real GDP) picked up in the latter half of the 1960s and into the first half of the 1970s with average annual growth rates of 12.7 percent and 9.0 percent for the two periods. Furthermore, real exports grew very rapidly, an average rate of over 30 percent per year for both periods. Real exports grew much more rapidly than total real GDP, suggesting that the export sector had become an "engine of growth" for the Korean economy.

During the 1976-80 period, real exports grew at less than half the rate of the previous five-year period. Between 1979 and 1980, real GDP declined 3 percent, the first downturn since the 1960s, and real exports stagnated in 1979 before picking up in 1980. 13/ Observers have attributed this decline to a number of factors. Korea was hit hard by the explosion in world oil prices in 1978. While Korea managed to minimize the effects of the first oil crisis in 1973-74, the second crisis proved to be too great. The crisis also led to a general economic slowdown, especially in the United States and Japan, its major export markets. Furthermore, Korea was facing growing protectionist attitudes in the West against labor-intensive products. President Park's assassination in 1979 also contributed to the economic instability. 14/

In the late 1970s, the Korean Government shifted its economic strategy towards promoting the development of capital-intensive industries, such

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12/ CRS calculations based on data in International Monetary Fund. International Financial Statistics. Yearbook. 1981. pp. 268-269.

13/ CRS calculations based on International Financial Statistics. Yearbook 1981. p. 268-271.

14/ See for example, Kim, Kwang Suk. Lessons from South Korea's Experience with Industrialization, p. 70-73.

as steel, shipping, machines and chemicals. Increasing Korean wage rates were reducing the country's comparative advantage in labor-intensive exports. In addition, the United States was reducing its military presence in Korea, and the government felt the need to develop its own defense industries to decrease its dependence on the United States. The government used a series of incentives, such as credit allocations, to promote capital-intensive industries. This policy led to an allocation of resources away from the labor-intensive industries to the capital-intensive industries, which contributed to the overall downturn in Korean economic activity during the late 1970s and early 1980s. 15/

As table 1 indicates, real GDP increased in 1981 and through 1985, but at rates below those achieved in the late 1960s and early 1970s. Exports still remain a major factor in Korean economic growth as real exports have grown much more rapidly than the rest of the economy.

TABLE 2. Commodity Structure of Korean Exports
(Percentages of total exports)

	1965	1975	1980	1984
Total	100.0	100.0	100.0	100.0
Non-Manufactures	39.0	18.5	9.8	8.3
Manufactures	60.9	81.4	90.2	91.7
Chemicals	0.2	1.4	4.5	3.1
Basic Manufactures	37.9	29.1	35.7	25.2
Machines and Transportation Equipment	3.1	13.8	19.7	35.3
Misc. Manufactures	19.7	37.1	30.3	28.1

Source: CRS calculations based on United Nations trade data obtained from the TradeNet computerized data retrieval system.

The role of manufactured products in Korean exports has grown substantially over the years. In 1965 about 61 percent of Korean exports were manufactured goods, but about 92 percent were in 1984. More significant has been the shift in commodity specialization within the manufactured goods sector. In 1965, most of the manufactured goods exports were in the labor-intensive categories of basic manufactures (leather goods, wood products, textiles) and miscellaneous manufactures (travel goods, wearing apparel, footwear). The more capital-intensive sector, machinery and transportation equipment accounted for about 3 percent of total Korean exports in 1965. By 1984, the total shares of labor-intensive goods (basic and miscellaneous manufactures) remained about the same, that of the capital-intensive sector had increased to 35 percent,

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15/ Ibid.

evidence that South Korea has been industrializing. Non-manufactured exports consist mostly of food products.

B. Taiwan

The background against which Taiwan launched its export-led development offensive was similar to that of Korea. Taiwan faced the post-war era with the legacy of 50 years of Japanese rule. This legacy left some benefits, including an established infrastructure (water supply system, transportation, and agricultural development). 16/ But intensive allied bombing, Japan's World War II defeat, and its forced withdrawal from Taiwan drained the economy.

Taiwan was critically affected by the Communist takeover of the mainland in 1949 and the Nationalist government's subsequent assumption of power on Taiwan. These events sent the Taiwan economy into a tailspin. Among other things, Taiwan lost its two most important export markets, Japan and mainland China, leading to large trade deficits. The economy faced hyperinflation that got underway at the end of the Japanese occupation and peaked at an annual rate of 4600 percent in May 1949. 17/

In the early 1950s, the Nationalist Government imposed an import-substitution policy to develop light industries, such as textiles, and to resolve its balance of trade deficits. But, as in the case of Korea, economic growth was constrained by the limitations of the small Taiwan economy and by a military threat which required large defense expenditures. In addition, Taiwan's balance of trade deficits worsened. Taiwan was also heavily dependent on American aid for foreign reserves.

The Government implemented an agricultural reform program, under which it divided up large land-holdings and sold them to tenant farmers. Some scholars have cited land reform as an important building block for Taiwan's eventual industrialization drive. 18/

Beginning in 1958 and into the 1960s, the government laid the foundation for an export promotion strategy which remains the basis for Taiwan economic policy today. By 1961, it reformed its multiple exchange rate system into a unitary system. In addition, the government devalued

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16/ Kuo, Tai-chun. An Analysis of the Taiwan Experience: Policies and Social Factors. Issues and Studies. January 1985. p. 109.

17/ Liu, Fu-Chi. Studies in Monetary Development of Taiwan. Taipei. Academia Sinica. 1970. p. A19.

18/ Ho, Samuel P.S. South Korea and Taiwan: Development Prospects and Problems in the 1980's. Asian Survey, December 1981. vol. 21. p. 1176.

the local currency to improve the price competitiveness of Taiwan exports. 19/

The Nationalist Government also reformed some of the import controls to allow exporters to obtain inputs at world competitive prices. Quotas on imports of materials were loosened. 20/ Exporting companies could also obtain rebates on customs duties paid on imported raw materials.21/ Like Korea, Taiwan still protects certain domestic industries from foreign competition through high tariffs and import controls.

Beginning in 1965, the Taiwan government established export processing zones, that is, specially designated areas in which the government leases factory space to exporting firms. These firms benefit from duty-free treatment on imported inputs without going through the bureaucratic red-tape of obtaining customs-duty rebates. They also obtain preferential access to utilities and receive tax incentives. 22/ The government added other export incentives as well: short-term loans for exporters at subsidized rates; tax exemptions on export-generated income; and cash awards for successful exporters. 23/

Taiwan has opened up its economy to foreign investment. The Statutes for Encouragement of Investment of 1960 provided assurances to foreign investors concerning expropriation. Since then, the government has added financial incentives: a five-year tax holiday, accelerated depreciation benefits, exemption from import duties, and preferential treatment on site locations. 24/ The government has given preferences to investments which increase exports and the flow of technology. 25/

The role of exports in Taiwan's economy has grown appreciably during the last two decades. Exports accounted for about 10 percent of total GNP in 1961 and over 50 percent in the 1980s. Table 3 provides a picture of what this trend has meant for the rest of Taiwan's economy.

19/ Scott, Maurice. Foreign Trade. in Galenson, Walter. ed. Economic Growth and Structural Change in Taiwan: The Postwar Experience of the Republic of China. Cornell University Press, Ithaca, New York, 1979. p. 331.

20/ Ibid., p. 331.

21/ Ibid., p. 325.

22/ Lin, Ching-yuan. Industrialization in Taiwan, 1946-72: Trade and Import-Substitution Policies for Developing Countries. New York, Praeger Publishers, 1973. p. 107.

23/ Scott, Foreign Trade, p. 342.

24/ SRI International. The Taiwan Development Experience and Its Relevance to Other Economies. p. 45.

25/ Ibid., pp. 45-46.

TABLE 3. Major Economic Indicators -- Taiwan
(Average annual growth rates)

	1961-65	66-70	71-75	76-80	81	82	83	84	85
Real GNP	8.8	9.2	7.8	10.0	5.7	3.3	7.9	10.9	4.7
Real Exports	12.9	23.6	17.1	21.2	10.0	2.7	18.6	15.7	N/A
Real Imports	13.2	17.6	13.0	12.4	-1.0	-15.2	13.1	2.1	N/A

Source: CRS calculations based on International Monetary Funds data. International Financial Statistics. Yearbook 1978 and 1979. Taiwan District. The Republic of China. Financial Statistics. The Central Bank of China. April 1985.

From the beginning of the 1960s through the 1970s, real exports grew about 15 percent per year on the average. Real GNP also grew at a very respectable rate of 7 percent per year on the average. The groupings of the years mask some difficulties Taiwan had in 1974 and 1975 when real GNP increased by only 0.6 percent and 2.4 percent, respectively. Real exports declined for the first time since 1960 in both of those years. The decline corresponded to the global recession associated with the oil crisis.

Taiwan's economy grew significantly in 1981, 1983, and 1984 led by high rates of growth in real exports. In 1982, a year of slow economic growth in the United States and other major export markets, real exports increased only 2.7 percent, which dragged real GNP growth down to 3.3 percent.

TABLE 4. Commodity Structure of Taiwan's Exports
(Percentages of total exports)

	1965	1975	1980	1984
Total	100.0	100.0	100.0	100.0
Non-Manufactures	57.5	18.7	11.9	6.1
Manufactures	42.5	81.3	88.3	93.9
Basic Manufactures	25.0	23.7	22.8	N/A
Machines & Transportation Equipment	4.4	19.6	23.6	N/A
Misc. Manufactures	8.3	36.1	39.1	N/A
Chemicals	4.8	1.9	2.8	N/A

Source: CRS calculations based on United Nations Trade data, TradeNet data retrieval system. 1984 data from The Republic of China. Board of Foreign Trade. 1985 Foreign Trade Development of the Republic of China.

In the mid-1960s, most of Taiwan's exports consisted of non-manufactured goods, generally food products. But as table 4 indicates, manufactured goods have been occupying increasing shares of total exports and account for over 90 percent today. While labor-intensive products make up increasing shares of manufactured exports, machines and transportation equipment have also been increasing their shares, a sign of Taiwan's industrialization.

C. Singapore

Singapore's economy has long been export-oriented because of its size and location. Throughout colonial rule under Great Britain (1819-1957), Singapore operated as an entrepot trade center: processing, repackaging, and re-exporting of primary products from Southeast Asia to the rest of the world and the re-export of manufactured goods from the industrialized countries to Asia. 26/

As a free-trade center, Singapore developed a highly efficient trade-related services sector: banking, insurance, and shipping. Revenue from these services allowed the local population to develop a standard of living higher than most of the other Asian countries. 27/ But this

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26/ Ropke, Jochen. The "Second Industrial Revolution" in Singapore. Asien, no.13, Oct. 1984. p. 47.

27/ Fong, Pang Eng and Linda Lim. Rapid Growth and Relative Price Stability. In a Small-Open Economy: The Experience of Singapore in Export-Oriented Development Strategies. p. 80.

legacy left the city-state port with few indigenous manufacturing capabilities to sustain its economy once trading patterns changed and once Singapore became independent.

For about eight years (1959-67), Singapore followed an import-substitution strategy of high protective tariffs and import controls for fledgling domestic light industries. This strategy permitted some growth, but the small economy could not sustain it. Singapore has returned to promoting its comparative advantage in exporting and has removed most of the import restrictions to allow for exporting firms to obtain inputs at competitive prices.

Singapore has encouraged foreign direct investment. Unlike many other developing countries, Singapore has not encumbered foreign investors with local equity participation requirements or other regulations which discourage foreign investment. In addition, the government has directed the allocation of foreign capital through incentives for foreign investment in targeted industries. 28/

Singapore has coupled its comparative advantage in exporting with foreign investment to develop an industrial base. Many multinational companies from industrialized countries have moved their operations to Singapore based on the favorable investment climate and low wage rates. Much of the development has been in assembly-type operations, especially electronics. Singapore is now entering a new phase of development in which it emphasizes capital- and technology-intensive industries, such as oil refining, petrochemicals, shipbuilding, electronics, and optics.29/ The government has even forced wage rates upwards in an effort to encourage shifts of investments from labor-intensive to capital-intensive industries.

28/ Fong and Lim, p. 89.

29/ Low, Linda. The Role of Public and Private Investment in Regional Security and Economic Development. A paper given at "Pacific Basin Security: Economic Dimension," a symposium sponsored by the National Defense University. February 13, 1986.

TABLE 5. Major Economic Indicators -- Singapore
(Average annual growth rates)

	1966-70	71-75	76-80	81	82	83	84	85
Nominal GDP	14.5	18.3	12.7	18.2	11.3	10.1	10.1	-1.0
Nominal exports	9.9	31.9	29.1	7.9	-1.2	4.7	10.2	-4.4
Nominal imports	10.7	29.0	24.8	15.1	1.6	0.2	1.8	-11.0
Real GDP	13.3	9.6	8.7	9.9	6.3	7.9	8.2	-1.7
Real exports	N/A	N/A	16.8	3.0	3.9	8.4	16.4	-2.8
Real imports	N/A	N/A	11.9	12.0	8.0	0.8	4.1	-6.9

Source: CRS calculations based on data in International Monetary Fund. International Financial Statistics. TradeNet Computerized data retrieval system. Chase Econometrics. Far East Forecasts and Analysis. First Quarter 1986.

As table 5 shows, Singapore achieved impressive economic growth from 1966 to 1984. In fact, from 1968 to 1984, Singapore achieved continuous growth. During that period, real GDP increased at an average rate of 8.5 percent per year. Foreign trade has been the chief component. In 1984, the ratio of exports to GNP was 137 percent, reflecting the preponderance of economic activity devoted to domestic exports and entrepot trade. [30]

In 1985 Singapore incurred its first recession in two decades when real GDP declined by 1.7 percent. Official government reports cite a number of reasons for the sudden decline. Wage rates in Singapore have increased relative to labor productivity, causing Singapore's competitiveness in labor-intensive production to decline. In addition, Singapore's exports declined by 3 percent. During the previous export slump (1981-82), Singapore managed to maintain economic growth through public sector investment in construction. But apparently the economy has become saturated with such investments. [31]

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[30] CRS calculations based on data in International Monetary Fund. International Financial Statistics. May 1986. U.S. Department of State. Foreign Economic Trends. Report from Singapore. Washington, September 1985. p. 2.

[31] Ministry of Trade and Industry. Republic of Singapore. Report of the Economic Committee. The Singapore Economy: New Directions. February 1986. pp. 38-41.

TABLE 6. Commodity Structure of Singapore's Domestic Exports
(Percentages of total exports)

	1965	1975	1980	1984
Total	100.0	100.0	100.0	100.0
Non-Manufactures	68.9	58.2	51.7	47.4
Manufactures	31.1	41.8	48.4	52.6
Basic Manufactures	11.9	8.5	8.3	7.2
Machines & Transportation Equipment	10.5	22.7	26.4	32.5
Misc. Manufactures	5.0	6.9	6.6	7.3
Chemicals	3.7	3.7	7.1	5.6

Source: CRS calculations based on United Nations trade data. TradeNet computerized data retrieval system.

Singapore's exports show a heavy concentration of non-manufac- tured goods. Much of these exports are in the mineral fuels sector, especially petroleum products. However, the table shows a trend towards increasing concentrations of manufactured goods, from about 31 percent in 1965 to over 50 percent in 1984. Furthermore, most of the manufactured goods exports are from the capital-intensive sector, machinery and transportation equipment, which may reflect Singapore's recent efforts to encourage capital-intensive sectors.

D. Hong Kong

From the establishment of British colonial rule in 1832 to the mid-1950s, Hong Kong operated as a center for entrepot trade between China and the United Kingdom. As in the case of Singapore, Hong Kong's role as a trade facilitator led to the establishment of a highly efficient and modern trade-services sector, that is, banking, communications, shipping, and insurance, but little in the way of indigenous manufacturing.

Several events in the 1950s disrupted Hong Kong's trade posture. The 1949 Communist takeover of the mainland led to the beginning of waves of Chinese immigrants to Hong Kong. The economic boycott of China by the Western countries following the Korean War drastically reduced the demand for Hong Kong's entrepot services.

From the late 1950s through the 1960s, Hong Kong developed its own manufacturing sector based on labor-intensive industries, such as textiles and wearing apparel. Hong Kong combined its comparative advantage in foreign trade, a legacy of its entrepot days, with its abundant supply of hard-working, skilled labor, a product of the massive Chinese immigration.

In contrast to the three other East Asian NICs, Hong Kong's industrialization efforts have not been the product of government-directed policies. Instead, the colonial government of Hong Kong has followed a policy of "positive non-interventionism." In other words, the government has not encouraged exports with incentives, nor has it imposed restrictions on imports. In addition, it has not directed investments into specific sectors but has allowed the market forces to decide the direction of production.

Entrepot trade has re-emerged as an important element in Hong Kong's economy since the 1970s. China's "open-door" policy, flourishing trade between the West and China, and the overall surge in East Asian commerce have increased demand for these services.

Hong Kong faces increasing competition from other Asian coun- tries, including China, for markets in labor-intensive goods. Prosperity has led to higher wage levels in Hong Kong, reducing its comparative advantage in labor-intensive exports.

In a break with its non-interventionist tradition, the Hong Kong government has taken steps to encourage the development of domestic, capital-intensive industries. The government arranges industrial support facilities and technical services to help with diversification. A government advisory committee report indicated the government would have to help direct the economy, if Hong Kong is to compete in world trade. 32/

The role of the foreign trade sector in the Hong Kong economy is significant, and, as in the case of the other three East Asian NICS, is growing. In 1975, the ratio of exports to GDP was 75 percent. In 1985 it reached over 100 percent, which reflects the importance of domestic export and re-export activity. Between the same two years, the import/GDP ratio also increased from about 75 percent to over 100 percent. 33/ The role of re-exports has also increased with the demand for Hong Kong's entrepot services. Between 1975 and 1985 the share of re-exports in total Hong Kong exports grew from 23 percent to about 45 percent. 34/

32/ Nyaw, Mee-Kau and Chan-leong Chang. Structure and Development Strategies of the Manufacturing Industries in Singapore and Hong Kong: A Comparative Study. Asian Survey, v. 22, May 1982. p. 463-464.

33/ CRS calculations based on data in Chase Econometrics. Far East Forecasts and Analysis. Third Quarter 1985 and Long-term Update and First Quarter 1986.

34/ Ibid.

TABLE 7. Major Economic Indicators -- Hong Kong
(Average annual growth rates)

	1966-70	71-75	76-80	81	82	83	84	85
Real GDP	7.9	5.4	12.4	9.4	2.9	6.5	9.4	3.7
Real Exports of Goods & Services	13.1	4.0	15.5	13.9	-1.9	13.7	25.0	-1.6
Real Imports of Goods & Services	11.4	4.8	17.8	12.8	-1.8	9.9	18.0	2.5

Source: CRS calculations based on data in United Nations Yearbook of National Accounts Statistics. 1976 and 1982. (for 1966-1980 figures). Chase Econometrics Forecasts and Analysis. Far East. First Quarter 1986 (for 1981-85 figures).

The data in table 7 illustrate the importance of the trade sector in the Hong Kong economy. During the 1966-70 and 1976-80 periods, real exports of goods and services increased at robust rates of about 13 percent and 16 percent, respectively. During the same two periods, real GDP grew at about 8 percent and 12 percent. Exports grew at a more rapid rate than the economy as a whole, suggesting that they may have acted as an engine of growth. In the 1971-75 period, the export sector probably dragged the economy, since they increased by only 4 percent, while real GDP grew slightly above that rate, at 5 percent per annum on the average.

The relationship has carried forward into the most recent years, as real GDP increased at very high rates in 1981 (9.4 percent), 1983 (6.5 percent) and 1984 (9.4 percent) led by high rates of export growth during those years. Declines in real exports in 1982 and 1985 appeared to drag the economy into low growth.

TABLE 8. Commodity Structure of Hong Kong Exports
(Percentages of total exports)

	1965	1975	1980	1984
Total	100.0	100.0	100.0	100.0
Non-Manufactures	6.5	3.0	3.8	3.9
Manufactures	93.4	97.2	96.0	95.1
Basic Manufactures	22.0	13.5	11.3	10.0
Machines & Transportation Equip.	6.8	14.6	17.5	23.4
Misc. Manufactures	63.5	68.1	66.4	61.7
Chemicals	1.1	1.0	0.8	0.0

Source: CRS calculations based on United Nations Trade data obtained from the TradeNet data retrieval system.

Well over 90 percent of Hong Kong's domestic exports have been manufactured goods. Over the years, labor-intensive products (basic and miscellaneous manufactures) have accounted for 70-80 percent of the exports. Table 8 shows, however, that capital-intensive exports (mainly machinery and transportation equipment) are occupying growing shares indicating Hong Kong's industrialization.

In 1984 the United Kingdom and the People's Republic of China reached an agreement concerning the return of sovereignty over Hong Kong to China in 1997. According to the agreement, the PRC will permit Hong Kong to maintain its market-oriented economy for at least 50 years after its return to Chinese control.

IV. SOME COMPARISONS

This overview of the economic development records of the four East Asian NICs reveals some similarities, which may shed light on the factors underlying the NICs' economic successes over the past two decades. All four countries have used their export sectors as the main driving force for growth and development. In Korea and Taiwan, the importance of exporting has grown over the last two decades to become the major factor in the economies. Exporting has played a vital role in Hong Kong and Singapore for the past two centuries by virtue of their positions as important ports and trade centers. In all four countries the health of the overall economies depends in large part on the health of the exporting sectors.

In addition, all four countries have been developing their industrial bases largely through the trade sector. In the past, they imported capital-intensive goods and technology and exported labor-intensive goods. To varying degrees, the East Asian NICs now produce more capital-intensive goods, a sign of further industrialization.

In three East Asian NICs -- South Korea, Taiwan, and Singapore -- the government has been a determining force in economic development.

The governments of Taiwan and South Korea shifted the courses of economic growth and development in the 1960s and have since fostered exports through a program of tax benefits and other incentives. They both still protect fledgling domestic industries through import controls and restrictions on foreign investments, which offset some of the aggregate trade effects of the export subsidies. Singapore's government has maintained a "hands-off" posture on foreign trade but has influenced the direction of domestic and foreign investments into industries it deems vital to economic development.

Only Hong Kong's government has followed a virtually free-market economic policy. But even Hong Kong shows signs of retreating from its traditional policy of "positive non-interventionism."

Over the past two decades all four NICs have experienced relative political stability, which may have contributed to their economic success. One exception was the assassination of South Korean President Park, which some analysts have cited as a factor in Korea's brief economic slowdown in the early 1980s. British-Chinese negotiations over Hong Kong's future may have led to some uncertainty in that city-state. The four NICs have not incurred any severe external political or military crises during this period, although South Korea and Taiwan maintain large, well-equipped armed forces to defend themselves against military threats. The four countries benefited from increase commercial activity in the region resulting from the Vietnam war in the 1960s and 1970s.

The four East Asian NICs are resource poor but labor abundant. Therefore, they could not rely on exports of primary commodities, such as petroleum, for foreign exchange. They developed their labor-intensive manufacturing industries, because they had nothing else. Prices for manufactured goods are generally less volatile than primary commodities; therefore, the four East Asian NICs have avoided some of the uncertainties that Mexico, Indonesia, and other petroleum producers have faced.

Analysts have cited other similarities, for example, the Confucian heritage which the four East Asian NICs share. They specifically cite its emphasis on education, discipline and hard work as a possible factor in their economic successes.

V. THE ROLE OF THE UNITED STATES AND ITS POLICY IMPLICATIONS

South Korea and Taiwan have been dependent on U.S. arms and the special protection the United States has extended because of their vital importance to U.S. national interests. This armed support undoubtedly has helped create an environment in which the two NICs could perpetuate their economic success.

Aside from the military support, the United States has been a significant factor in the economic success of the East Asian NICs by virtue of its role as their most important export market. In recent years, the United States has bought roughly one third of the exports and has ranked as the number one export market. Moreover, these purchases have included about 40 percent of total manufactured exports from the East Asian NICs. Japan has bought about 10 percent of the NICs' exports and has ranked number two as an export market (except for Singapore where it ranks number three behind Malaysia.) 35/

Because of American dominance as an export market, the East Asian NICs are very sensitive to economic developments in the United States, such as growth rates, and to policies which could affect their access to the U.S. market. Strong U.S. economic growth can help bolster the NIC economies as it generates demand for their exports. U.S. recessions can impede NIC economic growth.

Recent U.S. steps to limit imports affect the access of some East Asian NICs to the U.S. market, especially in manufactured goods. The United States is now negotiating new, lower import quotas on textiles, a major export from Hong Kong, South Korea, and Taiwan. The United States has also negotiated bilateral agreements with South Korea and other steel producers, to limit shipments to the United States, from October 1, 1984 to September 30, 1989. The agreement limits Korea's penetration of the finished steel market in the United States to a 1.9 percent share and U.S. imports of semi-finished steel from South Korea to 50,000 tons.36/ The United States concluded these agreements because of the American steel industry's concern with the rapid growth of competiton from foreign steel producers.

The four NICs have relied on imports of capital-intensive goods and technology to develop their industrial bases. The United States has ranked number two in the four East Asian NIC markets as an import supplier. It accounted for 18 percent of total East Asian NIC imports in 1984. Japan has been the number one import supplier, having accounted for over 25 percent. 37/

The seeming disparity in the U.S. positions as a purchaser of exports and supplier of imports to the East Asian NICs has concerned some U.S. industries and policymakers, particularly over the last few years as the U.S. trade deficits have reached record-breaking levels. In 1985, the United States incurred a $25 billion total trade deficit with the four East Asian NICs, which represented about 17 percent of the $148.5 billion total trade deficit for the United States in 1985 and equaled over 50 percent of the $49.7 billion U.S. deficit with Japan. 38/

35/ CRS calculations based on data in International Monetary Fund. Direction of Trade Statistics. 1985 Yearbook. Taiwan data contained in The Republic of China. Board of Foreign Trade. Foreign Trade Development of the Republic of China. 1985.

36/ U.S. Library of Congress. Congressional Research Service. The President's Steel Program: Background and Implementation. Report No. 86-658 E, by David J. Cantor. Washington, April 1, 1986. p. 5.

37/ Ibid.

38/ CRS calculations based on data in U.S. Department of Commerce. International Trade Administration. Business America, March 17, 1986. p. 5.

billion total trade deficit for the United States in 1985 and equaled over 50 percent of the $49.7 billion U.S. deficit with Japan. 38/

The Congress and the Executive Branch have tightened eligibility requirements for some East Asian NICs and other advanced developing countries under the Generalized System of Preferences Program for duty-free treatment. Under the Trade and Tariff Act of 1984, imports of certain products from advanced developing countries can be denied GSP benefits, if their total value exceeds $25 million or 25 percent of total U.S. imports of that product. 39/ This threshold is lower than that for other GSP recipients. The United States is also pushing South Korea and Taiwan to reduce barriers to U.S. exports that protect domestic industries and become full, participating members in the international trading system.

VI. OUTLOOK FOR THE REMAINDER OF THE 80s

The economic outlook for the East Asian NICs depends on a number of factors. The East Asian NICs will probably continue to rely on exporting as the chief impetus to economic growth and development. The United States will probably remain their number one export market. Therefore, economic conditions within the United States will be a factor. Robust U.S. economic growth will generate demand for imports which will feed East Asian NIC economic growth. On the other hand, a sharp slowdown or recession, especially over an extended period of time, could hinder those prospects. The NICs could rely on increases in government spending, private consumption, and public sector and private sector investments to mitigate the effects of a slowdown in the export sector. But given the importance of exporting to all four economies, such remedies would only be short-term solutions. The East Asian NICs will also be sensitive to economic conditions in Japan and the other industrialized countries.

Access to export markets will be another determining factor. Over the next few years, the East Asian NICs will closely watch U.S. policymakers grapple with the trade deficit problems. They will be sensitive to any moves to limit U.S. imports, particularly in those sectors in which they have achieved a comparative advantage, such as textiles, footwear, and electronic assembly, or those in which they could become competitive, such as steel and autos. The NICs will look to increase their access to markets in Japan, the European Economic Community and other industrialized countries. If Japan's economic strategy becomes domestic-oriented, it could create export opportunities for the NICs.

Hong Kong, Korea, and Taiwan are dependent on foreign energy sources. The recent oil glut has been a boon to their progress. Continued low

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38/ CRS calculations based on data in U.S. Department of Commerce. International Trade Administration. Business America, March 17, 1986. p. 5.

39/ Section 505. Trade and Tariff Act of 1984. Public Law 98-573.

prices would brighten their economic prospects. But sharp increases in world oil prices, similar to those of 1973-74 and 1978, could severely hamper those prospects. The NICs managed to survive the previous crises without severe damage to their economies. But as they become more capital-intensive, their dependence on petroleum will increase as will their vulnerability to future oil price shocks.

The oil picture for Singapore is mixed. Singapore has developed oil refining into a major industry, and thus is affected inversely by the world oil situation. But as it becomes more industrialized, it too may benefit from cheaper oil.

Over the past two decades, the East Asian NICs have maintained exchange rates that benefited their exports. They have devalued their currencies against the dollar and tied their exchange rates to the U.S. dollar or a basket of currencies, which has helped maintain the price competitiveness of their exports in the United States. Exchange rate policies will remain an important factor in economic prospects for the remainder of the 1980s. In addition, Taiwan and Korea compete with Japan for shares of the U.S. market in some commodities. The current appreciation of the yen against the dollar, has made Japanese products more expensive in the U.S. market and increased the attractiveness of Korean and Taiwanese goods.

The East Asian NICs face strong competition from other Asian countries, including the ASEAN members and China, in labor-intensive production. The economic prospects of the NICs, therefore, will depend on their ability to become competitive at higher stages of industrialization.

The East Asian NICs face political and military uncertainties the outcome of which will help determine their economic progress for the remainder of the 1980s. Taiwan confronts the prospect of powerful, aging leaders leaving the scene in the near future. The South Korean leadership faces challenges from dissidents. Hong Kong prepares for its return to China. How the East Asian NICs manage these uncertainties will be a factor in their economic prospects.

CHAPTER 4

INDONESIA, MALAYSIA, THE PHILIPPINES, AND THAILAND*

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I. BACKGROUND: THE COLONIAL LEGACY

Indonesia, Malaysia, the Philippines, and Thailand are sometimes described as a potential second wave of Asian NICs which have adopted the export-led growth strategies of Japan, South Korea, and Taiwan. There is truth in this assertion, but it misses the key point that the economies of these countries were export-oriented long before the 1960s when the NICs began to emerge. During the periods of colonial rule in Indonesia, Malaysia, and the Philippines, the patterns of economic development imposed by the colonial powers stressed the export of agricultural commodities and natural resources. Such exports provided needed and inexpensive products for the domestic economies of the colonial powers or were used as major income earners for the colonial powers in other developed markets. 1/

In Indonesia, for example, the Dutch government and later private interests created a huge system of plantations for export crops like coffee, sugar, indigo, tea, palm oil, and tobacco. British rule in Malaysia saw the country's wealth dependent on exports of tin and rubber. The economic legacy of American rule of the Philippines was an export crop economy oriented towards the American market. Sugar, coconuts, lumber, and abaca constituted the main lines of production. Even Thailand, which retained its independent status, allowed (sometimes under pressure) British business interests to develop the tin, rubber, and logging sectors.

All of these countries had two sectors by the eve of World War II: a modern export sector and a subsistence agricultural sector. There was little industry except for processing plants for export commodities. Most manufactured products were imported, mainly from the colonial power under tariff-free arrangements.

These systems were exploitative in many ways and prevented a more rounded economic development. They did, however, provide substantital benefits as well such as large-scale employment in the commodity sector (both on the plantations and among individual producers of commodities on small plots, so-called small-holders), the development of an indigenous commercial class (often, though, ethnic Chinese), considerable infrastructure, and the flow of some export income back into the indigenous economy.

Though the nations had achieved independence, the "colonial pattern" prevailed in the four economies in 1960. Indonesia suffered from misrule under Sukarno, with little new economic development and the existing sectors in decline. Malaya gained independence in 1957 (the Federation of Malaysia was formed in 1963) with the economy dependent on tin and rubber. The Philippines had developed a more varied industrial sector by 1960, but it was geared to the domestic market and was dependent on imports of equipment and raw materials.

1/ For a discussion of the Southeast Asian economies under colonial rule, see Pluvier, Jan. South-East Asia from Colonialism to Independence. Kuala Lumpur, Oxford University Press, 1974. p. 3-71.

Foreign exchange earnings relied on commodities and natural resources, and these were insufficient to finance needed imports. Thailand differed from the other three in that it had a major rice-exporting sector, but other features of its economy were similar to Indonesia, Malaysia, and the Philippines.

II. ECONOMIC DIVERSIFICATION, 1960-1980

Diversification of the export sector was a key element of the economic strategy of the four countries during the 1960-1980 period. It was this period in which the present national economies of these nations were shaped. The degree of diversification varied from country to country, but diversification had four aspects: (1) the development of new lines of commodity exports; (2) attempts to upgrade the commodity sector with processing of raw products into finished goods; (3) more emphasis on energy exports, and (4) the development of labor intensive industries aimed at foreign markets.

Diversification was greatest in Malaysia and Thailand. Malaysia created palm oil and timber-producing sectors which became at least as important as rubber and tin as foreign exchange earners. By 1980, Malaysia was the world's largest producer of palm oil and accounted for about 65 percent of world trade in the product. 2/ Processing facilities were integrated into the production processes for palm oil and rubber. Other industries arose in textiles and garments, electrical machinery, and electronics products (semi-conductors and integrated circuits). Free trade zones were established for export-oriented manufacturing where manufacturers could import raw materials and machinery duty free. Malaysia also developed its oil and natural gas into a major export line. 3/

In Thailand, too, new agricultural commodities, like tapioca, maize and sugar, emerged as major exports by 1980. The Thai government, with assistance from the World Bank, conducted a massive replanting of rubber trees in the 1970s to revitalize that sector. Production and processing of pineapples for export boomed in the 1970s. Thailand's industry did not diversify to the extent of Malaysia's industries, except for commodity-processing plants. Textiles, however, was a growth industry of the 1960s and 1970s, and it accounted for nearly 25 percent of industrial production by the early 1980s. 4/ Manufacturing as a whole increased from seven percent of Gross Domestic Product (GDP) in 1951 to 18.6 percent in 1985. 5/

2/ Low, Linda. Malaysia Economy. The Far East and Australasia. London, Europa Publications, Ltd., 1986. p. 604.

3/ Ibid., p. 604-607.

4/ Dixon Chris. Thailand Economy. The Far East and Australasia. London, Europa Publications, Ltd., 1986. p. 915.

5/ Ibid.

The pattern in the Philippines differed in two respects. First, there was little diversification in the commodity sector. Coconuts, sugar, and copper continued to dominate. Bananas, pineapples, and other processed fruits entered the picture as export crops. The processing of copra into coconut oil made the latter a more important export product than the former.

Philippine manufacturing remained oriented primarily toward the domestic market. Industry had developed in the 1950s as a result of the government's policies of protecting domestic manufactures from foreign competition. These industries, however, were heavy importers of raw materials and machinery, helping to create frequent, large current account deficits. 6/

The Philippine government adopted policies in the 1970s designed to promote export-oriented manufactures, and some enterprises were established. Most industrial growth in the second half of the 1970s and early 1980s occurred in electronics, textiles and garments, and furniture. The electronics industry expanded exports from $12 million in 1972 to over $1 billion in 1982. Philippine semi-conductor firms reportedly assembled 20 percent of the world's output by the early 1980s. Exports of textiles and garments increased to $540 million in 1982. 7/

Diversification was least in Indonesia during the 1960-1980 period. This was partly due to the economic shambles that the Suharto government inherited from the Sukarno regime after 1965. The Suharto's government's initial strategy was aimed at financial stability, bringing triple-digit inflation under control, and increasing rice production. Moreover, the government foresaw the growing importance of oil and natural gas to the world, and its emphasis on the energy sector was reinforced by the 1973 world energy crisis. As a result, the export sector after 1973 was dominated by energy. By the end of the 1970s, petroleum and natural gas made up close to 80 percent of Indonesia's total exports and provided two-thirds of the government's revenues. The agricultural commodity sector, which had provided 70 percent of exports in 1969, was neglected for the most part. Despite favorable world market prices in the 1970s, rubber production increased only 1.1 percent per year on the average for that decade. Similar slow growth occurred in production of coffee, copra, tobacco, and tapioca. The only marked production and export increases occurred in sugar and palm oil. Timber exports also rose considerably, but not at the same pace as energy exports. 8/

The Suharto government's second five year plan (1974-79) placed little emphasis on the development of a labor intensive, export oriented

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6/ Dios, Emmanuel S. An Analysis of the Philippine Economic Crisis. Manila, University of the Philippines Press, 1984. p. 10.

7/ Turley, T. M. Philippine Economy. The Far East and Australasia. London, Europa Publications, Ltd., 1986. p. 821, 831.

8/ Buchanan, Ian. Indonesia Economy. The Far East and Australasia. London, Europa Publications, Ltd., 1986. p. 434-439.

industry. It was not until the third plan that diversification toward export industries (textiles, shoes, electronics, processed food, and processed lumber) became an integral part of development strategy.

Several factors influenced the Malaysian, Thai and Philippine governments, and subsequently, the Indonesian government, to embark on a strategy of export diversification. One was the Kennedy Round trade negotiations held in 1964 among 53 nations representing 80 percent of all world trade. The Kennedy Round produced agreements for tariff cuts, averaging 35 percent for all participants, on a broad range of industrial products; lowered tariffs on agricultural products; and produced agreement by the developed countries (the United States, Japan, and Western Europe) to reduce barriers to exports from developing countries. 9/ The result was a liberalized international trading environment that opened up opportunities for exports from the Southeast Asian countries, especially of manufactured and processed products.

A second factor was the influence of the World Bank and International Monetary Fund. All four countries drew on the lending facilities of these institutions and thus were influenced by the conditions imposed on them by the institutions. The World Bank and IMF invariably advocated a diversification strategy stressing a relaxation of trade barriers and the development of export industries.

IMF and World Bank influence increased after the first oil crisis in 1973. Sharply rising oil prices and worldwide inflation pushed the value of imports up sharply for all four countries, but especially the Philippines and Thailand. The resultant current account deficits forced them to draw on the IMF for balance of payments assistance. Part of the IMF formula was for these countries to export their way out of these deficits.

This view was easily adopted by the Western educated technocrats who came on the scene in the 1960s to direct economic policy in the ASEAN countries. Indonesia's "Berkeley Mafia" gained a unique fame, but economists educated in the United States and Great Britain have had nearly equal influence in the other countries. All were oriented toward free market ideas, including the opportunities of the liberal trading system.

Finally, all four countries were oriented politically toward the West. The Philippines and Thailand were treaty allies of the United States. Malaysia had defense ties with Great Britain, Australia, and New Zealand. Indonesia had no formal defense ties with Western countries, but the Suharto government, reversing the Sukarno posture, looked to the United States for military and economic assistance and kept ties with the Soviet Union and China at minimal levels.

9/ U.S. Department of State. The Trade Debate. Washington, D.C., 1979. p. 7.

There can be little question that this political orientation influenced the economic and trade policies of these governments. The political influence of the United States and other Western countries flowed into economic issues. U.S. and Western economic aid programs produced a steady dialogue on the recipient countries' economic policies. Consultative groups of aid-giving Western countries were formed, and these groups formalized the dialogues into periodic reviews of the recipient countries' economic performances and policies. Furthermore, Thailand, Malaysia, and the Philippines successfully fought serious communist insurgencies, and Western aid was critical to the victory of the established leaderships.

III. THE ECONOMIES IN THE 1980s

A. Indonesia

Indonesia's economy is the least developed of the ASEAN economies. The country is rich in natural resources, and the economy grew at a respectable rate of nearly eight percent per year after 1970. The key to this growth was rising prices for Indonesia's oil exports. GDP growth, however, fell to 2.2 percent in 1982 as oil revenues declined. The growth rate rose to 3.0 percent in 1983 and 5.8 percent in 1984 but fell to 2.5 percent in 1985 due again to falling demand and prices for petroleum exports. The rapid drop in world oil prices in early 1986 foretold a further decline in GDP growth, probably to around one percent.

Indonesia remains poor. Over 40 percent of Indonesia's 160 million people fall below the World Bank's "absolute poverty" base. [10] The major problems are overpopulation (an estimated 160 million people), limited agricultural output, and weak manufacturing and export sectors except for petroleum.

The population problem is compounded by the fact that the island of Java, with one-thirteenth of the country's total area, contains almost two thirds of the population. Population density in rural Java is about 565 people per square kilometer (or 1465 people per square mile). This, coupled with disparities in land ownership and the large number of landless peasants, has resulted in widespread rural poverty and unemployment. A vigorous government program to control the population has reduced the growth rate from nearly three percent in the mid-1960s to an estimated 2.1 percent in 1984. [11] Moreover, observers have noted some improvement in living standards in rural Java in areas such as quality of housing, production, and availability and access to consumer goods. Nevertheless, Indonesia faces the formidable task of absorbing 1.8 million new job seekers annually into the labor force.

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[10] U.S. Agency for International Development. Congressional Presentation, Fiscal Year 1986. Annex: Asia. p. 91.

[11] Ibid., p. 86

Agriculture accounts for about 28 percent of Gross Domestic Product and employs over 55 percent of the labor force. Production of rice, the main food crop, has risen from 12.3 million tons in 1969 to over 25.8 million tons in 1984. This has brought Indonesia closer to self-sufficiency in rice, but the country has had to import large amounts of rice annually in recent years. Production of other food crops has not grown as rapidly and has stagnated in some cases.

Manufacturing accounts for about 13 percent of GDP and employs about nine percent of the labor force. Industrial production has risen rapidly since 1970, but this has been mainly in capital-intensive industries such as cement, fertilizer, and petrochemicals. Labor-intensive and commodity processing industries remain relatively weak.

Exports make up nearly 25 percent of Gross National Product. Oil and natural gas are the most important exports ($13.9 billion in the 1984-1985 fiscal year, composing 65 percent of the overseas sales and 60 percent of the government's revenues). 12/ Non-oil export earnings--primarily from coffee; rubber; wood and wood products; and, very recently, palm oil, textiles, and electronics--have grown more slowly to an estimated $6.1 billion in the 1985-86 Indonesian fiscal year. Manufactured goods comprise only about seven percent of total exports, well up from the percentage of the late 1970s but still low.

B. Malaysia

Malaysia has made substantial progress in the last ten years, and its per capita GNP of over $1,900 is one of the highest in Asia. Economic growth averaged nearly eight percent per annum during the 1970s and over five percent so far in the 1980s. The level of growth and government policies have resulted in a broadening distribution of economic benefits. Using the Malaysian government's standard, the incidence of poverty declined from 49 percent of the population in 1970 to 29 percent in 1980. 13/ Urbanization has been rapid, with city dwellers now approaching 40 percent of the population. Rural poverty, however, remains a problem, particularly among rice farmers and rubber workers.

An industrial base has arisen to complement the production of oil and raw materials such as tin, rubber, lumber and palm oil. Manufacturing output accounts for over 20 percent of Gross Domestic Product and has been the major source of growth in the economy since 1975. 14/ The electronics sector

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12/ U.S. Department of Commerce. Foreign Economic Trends and Their Implications for the United States: Indonesia. Washington, U.S. Government Printing Office, 1985. p. 5.

13/ The Far East and Australasia, 1982-1983. London, Europa Publications, Ltd., 1984. p. 741.

14/ U.S. Department of Commerce. Foreign Economic Trends and their Implications for the United States: Malaysia. Washington, U.S. Government Printing Office, 1986.

has become especially important as a growth industry, an exporter, and an employer (80,000 employed in 1985). Nearly all U.S. semi-conductor companies have operations in Malaysia. 15/

Industry has been the main provider of new employment in recent years. Annual increases in employment in manufacturing since 1975 have been near ten percent or higher. This resulted in a steadily declining rate of national unemployment in the late 1970s into the early 1980s. By 1985, manufacturing accounted for over 15 percent of the total labor force.

Agriculture remains the major component of the economy, accounting for over 20 percent of GDP and employing 35 percent of the labor force. Food production had developed to a point where Malaysia produced 80 to 90 percent of its food needs compared to 55 percent at the time of indepedence in 1957, but recent delines reduced the percentage to about 60 percent.

Malaysia's economy is dependent on commodity exports of petroleum, rubber, palm oil, timber products, and manufactured articles. Exports account for over 50 percent of Gross National Product. 16/ Because of the growth of industry, manufactures now account for over 30 percent of total exports, compared to about 20 percent at the end of the 1970s.

C. Philippines

The Philippines today faces the most serious economic crisis in its modern history. 17/ Gross National Product declined by over five percent in 1984 and over three percent in 1985. Economic forecasters predict a further decline in 1986. The crisis has many components which feed upon one another. The inability of the Philippines to pay its foreign debt resulted in a cutoff of foreign capital for nearly two years. The business sector, which utilized foreign capital to finance imports, has been crippled, operating at below 50 percent of capacity. Little new investment has occurred since late 1983. Unemployment is at a rate of 20 percent, according to the Philippine government, and underemployment approaches 50 percent of the remaining adult work force. Government austerity measures taken in response to the debt situation sent interest rates for private borrowers to over 30 percent in 1985, and rates remain close to 20 percent as of July 1986.

External trade was a major factor in creating the conditions that led to the present crisis, and it has contributed to the prolongation of the economic depression. Dependence on imported oil resulted in escalating imports bills from 1973 to 1983, distortions of the import sector, and strains on Philippine financial resources. The cost of imported oil, for example, climbed from $890 million in 1976 to $2.4 billion in 1981, before

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15/ Ibid.

16/ Low, Malaysia Economy. p. 607.

17/ Dios, An Analysis of the Philippine Economic Crisis. p. 2-15.

it began to level off. At this peak, oil accounted from over 30 percent of the value of all imports.

A second factor was the decline in international prices for all major primary product exports after 1979: coconut oil, sugar, copper, and timber and wood products. The coconut sector was hit especially hard. Exports of coconut oil and copra fell from $832 million in 1979 to $437 million in 1985. This had a devastating effect on domestic living standards since about 30 percent of all Filipinos (about 15 million people) are dependent in whole or in part on the coconut sector. Sugar exports fell from $416 million in 1981 to $218 million in 1985. Sugar-producing regions, especially Negros, have experienced severe hardships, including malnutrition among the families of hundreds of thousands of sugar workers. In addition to the impact of international prices, many observers asserted that government-imposed monopolies on the coconut and sugar sectors distorted the markets for those products and prevented producers from realizing full profits.

Copper was the third product to experience a sharp downturn in international price levels. Exports of copper reached a height of $679 million in 1980 before plummeting to $88 million (estimated) in 1985.

Manufactured exports have been a bright spot in the Philippine economy since 1979. Exports of electronics and electrical equipment shot up from $95 million in 1981 to $850 million in 1984 before dropping to slightly over $700 million (estimated) in 1985. Clothing exports increased from $217 million in 1979 to $407 million in 1981; since then, the level has been around $400 million. By 1985, exports of all manufactured products totalled an estimated $2.4 million, well over 50 percent of the total estimated exports of $4.5 billion. 18/

D. Thailand

Thailand's economy has benefitted from a rich agricultural base, a large labor force, and the absence of problems associated with overpopulation. The economy grew by over seven percent annually in the 1970s and around five percent annually so far in the 1980s. According to World Bank estimates, the incidence of poverty fell from about 57 percent of the population in the 1960s to 25 percent in 1984. 19/

Agriculture dominates the Thai economy, accounting for over 20 percent of GDP and two-thirds of the labor force. Rice is the most important crop, but tapioca (cassava), maize, sugar, and pineapple production expanded rapidly in the 1970s and early 1980s. Rubber is an important crop, produced

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18/ U.S. Department of Commerce. Foreign Economic Trends and their Implications for the United States: Philippines. Washington, U.S. Government Printing Office, 1985. pp. 9-10.

19/ Agency for International Development. Congressional Presentations for Fiscal Years 1982 and 1985. See Annexes for Asia, section on Thailand.

in the south on smallholdings. Tin is the major mineral produced in Thailand.

Thai industry is composed mainly of processing plants for primary products: rice mills, tapioca processing, fruit canning, etc. Textiles and garments have become the major non-primary growth industry. Manufacturing growth has been steady, and the sector contributes nearly 20 percent to GDP and employs over ten percent of the labor force, or slightly over two million people. 20/

The external trade sector has two important elements. The first is Thailand's heavy dependence on foreign oil. The rise in oil prices of the 1970s resulted in steadily increasing Thai outlays for imported oil. Petroleum accounted for over 31 percent of Thailand's imports in 1981. The percentage subsequently declined due to falling oil prices and the substitution of domestically produced natural gas. Nevertheless, it still accounted for 22 percent of all imports in 1985.

The second element is the importance of primary products, processed and unprocessed, in the export sector. Four products--rice, tapioca, sugar, and rubber--made up about 35 percent of all exports in 1985. 21/ Products like processed fruit, tin, and maize bring the total close to 50 percent. In the manufacturing sector, textiles has become the major non-primary product with significant export growth, now making up about ten percent of total exports. Total exports comprise about 25 percent of Thai Gross National Product.

IV. FOREIGN DEBT ISSUES

Foreign debt emerged as a significant economic problem to the four ASEAN countries in the 1980s. The Philippines has experienced a debt re-payment crisis similar to those of a number of Latin American countries. Malaysia, Indonesia, and Thailand do not appear to be in acute danger at this time, according to knowledgeable bankers and economists, but the experts also stress that the debt problem in each of them has worsened and bears watching.

The origins of the problem lie in the second oil shock of 1979 and the subsequent international recession of 1980-1982. The sharp rise in world energy prices in 1979 resulted in a new round of import price increases for all of the countries. As the world recession set in, commodity prices plummetted for sugar, coconuts, tin, rubber, tapioca and other key exports of the ASEAN states. Oil prices subsequently began to fall with significant effects on Indonesia's export earnings.

20/ Dixon, Thailand Economy. p. 915.

21/ Wharton Econometric Forecasting Associates. Asian Economic Outlook, April 1986. p. 161.

This situation produced rising current account deficits, and the fall in export earnings and general economic performance put added pressure on the budget deficits of ASEAN governments. Governments resorted to increased foreign borrowings to fill these gaps. Foreign debts thus have risen for all of them. The following tables show the current account situation for each of the four countries from 1981 through 1986 and the size of their overseas debts and debt service ratios.

TABLE 1. Current Account Deficits, 1981-1986
(billions of dollars)

	1981	1982	1983	1984	1985	1986 (est.)
Indonesia	.6	5.3	6.3	2.1	2.3	3.1
Malaysia	2.5	3.6	3.4	1.6	.9	1.7
Philippines	2.2	3.2	2.8	1.3	.8	.7
Thailand	2.6	1.0	2.8	2.1	1.6	1.6

Source: Wharton Econometrics Forecasting Associates

TABLE 2. External Debts (1981-1986)
(billions of U.S. dollars)

	1981	1982	1983	1984	1985	1986 (est.)
Indonesia	19.9	25.5	28.8	33.5	34.5	37.5
Malaysia	7.4	10.1	13.6	14.9	15.6	17.0
Philippines	20.3	24.5	24.9	24.4	25.6	27.0
Thailand	10.8	11.7	12.5	15.3	16.8	18.3

Source: Wharton Econometrics Forcasting Associates

TABLE 3. Debt Service: Principle & Interest as Percentage of Export Earnings, 1981-1986

	1981	1982	1983	1984	1985	1986 (est.)
Indonesia	10.0	12.6	15.5	19.0	25.2	26.4
Malaysia	5.1	7.1	8.5	8.0	9.1	11.1
Philippines	26.2	37.2	39.6	18.0*	35.7	41.9
Thailand	26.0	37.1	24.0	21.5	22.4	28.0

* Reflects moratorium on principal payments granted by lending banks.

Source: Wharton Econometrics Forecasting Associates

The economic policy response of the Indonesian, Malaysian, Philippine, and Thai governments have contained common elements, although they vary in intensity and in details. The main elements of the reactions are:

(1) Austerity at home: Either on their own initiative or under pressure from the International Monetary Fund, the ASEAN governments have restricted public spending. Economic development projects and programs have been postponed or cancelled.

(2) Restrictions on imports: The governments have raised duties on imports, imposed quotas, limited credit to private sector importers, and frozen construction projects in order to reduce imports of capital equipment.

(3) Governments have placed quantitative limits on foreign borrowing. Consequently, economic growth rates have tended downward in the 1980s. The following table shows the rates of GDP growth for the four ASEAN countries from 1981 through 1986:

TABLE 4. Rates of Growth in Gross Domestic Product, 1981-1986
(percent)

	1981	1982	1983	1984	1985	1986 (est.)
Indonesia	7.9	2.2	4.2	5.8	2.5	1.3
Malaysia	7.1	5.6	5.9	7.3	2.8	2.7
Philippines	3.8	3.0	1.0	-4.5	-3.7	-1.3
Thailand	6.3	4.2	5.8	6.0	4.1	3.8

Source: Wharton Econometrics Forecasting Associates.

Given domestic austerity, the dependence of these countries on exports for economic growth has grown. The importance of the U.S. economy and market, moreover, has increased relative to other importing countries. The year 1984 demonstrated this. U.S. economic growth for 1984 reached an impressive 7.1 percent. U.S. imports from the ASEAN countries also showed healthy increases as compared to 1983: Indonesia: $4.51 billion in 1983 to $5.65 billion in 1984; Malaysia: $2.20 billion in 1983 to $2.82 billion in 1984; Philippines: $2.16 billion in 1983 to $2.62 billion in 1984; Thailand: $1.0 billion in 1983 to $1.42 billion in 1984. Growth rates, as shown by the previous chart, also scored gains, except for the Philippines.

V. TRADE RELATIONS WITH THE UNITED STATES

Trade relations between the United States and ASEAN (including Singapore) are deepening. U.S. imports of ASEAN products increased by close to 200 percent during the 1977-1984 period. This compared to an increase in imports from all developing countries of less than 70 percent. The following table shows the growth of U.S. imports from individual ASEAN countries from 1977 to 1984:

TABLE 5. U.S. Imports from ASEAN
(millions of dollars)

	1977	1984
Indonesia	3,475	5,657
Malaysia	1,318	2,205
Philippines	1,110	2,622
Singapore	883	4,121
Thailand	346	1,426

Source: U.S. Commerce Department statistics. Brunei is not included since it did not join ASEAN until 1984.

The United States has become the key market for the manufactured products of these countries. Malaysia leads the way with over 70 percent of its exports to the United States as manufactured articles. Electronic components and parts provided the bulk of Malaysia's manufactured exports with $1.47 billion imported into the United States in 1984, according to Commerce Department figures.

The Philippines shows a similar pattern with 60 percent of U.S. imports from the Philippines in 1984 as manufactured goods. Electronic components and textiles and garments are the lead items.

The percentage for Indonesia is considerably lower because of the high volume of Indonesian oil sold to the United States and the lower level of manufactured exports overall. The United States, nevertheless, is the number one market for Indonesian manufactures. Textiles and garments, in particular, have emerged from $126 million in U.S. imports in 1980 to $261.3 million in 1984.

ASEAN also has emerged as a leading growth market for U.S. exports. The volume of U.S. exports to ASEAN countries is small compared to markets like the European Economic Community, Japan, the Latin American republics, Canada, and the Near East, but the rate of expansion over the last ten years has been considerably higher than for other markets. U.S. exports grew from $3.9 billion in 1977 to $8.4 billion in 1984.

Moreover, ASEAN has become a particular growth area for U.S. exports of technologically intensive products. U.S. statistics show that high technology items compose about 45 percent of all U.S. exports during the 1970s but that this category increased as a percentage of exports to ASEAN states from 46 percent in 1970 to over 70 percent by 1979. 22/

The following table shows the value of U.S. exports to ASEAN countries for 1977 and 1984 (in millions of U.S. dollars):

22/ Krause, Lawrence B. U.S. Economic Policy Toward the Association of Southeast Asian Nations. Washington, The Brookings Institution, 1982. p. 42-46.

TABLE 6. U.S. Exports to ASEAN
(millions of dollars)

	1977	1984
Indonesia	762	1,193
Malaysia	561	1,827
Philippines	876	1,709
Thailand	1,262	1,044

Source: U.S. Department of Commerce statistics.

According to U.S. trade figures, the United States is running trade deficits with each of the four countries. The deficit is highest with Indonesia because of U.S. imports of large amounts of Indonesian oil. Moreover, deficits rose considerably for the Philippines, Thailand, and Malaysia in 1984 when strong U.S. economic growth in that year produced a surge of imports from these countries. The following table shows the U.S. trade balance with the ASEAN countries and, for comparison, other East Asian countries for the years 1982-1984:

TABLE 7. U.S. Balance of Trade with East Asia
(millions of dollars)

	1982	1983	1984
Indonesia	-2,565	-4,211	-4,674
Malaysia	-248	-527	-998
Philippines	-121	-366	-913
Thailand	-94	-129	-382
Hong Kong	-3,433	-4,262	-5,837
Singapore	+896	+717	-490
South Korea	-677	-1,947	-4,188
Taiwan	-5,434	-7,709	-11,266

Source: U.S. Department of Commerce Statistics.

Trade between the four ASEAN countries and Japan in the 1980s so far shows a different pattern than trade with the United States. Except for Japanese imports from Malaysia, trade has declined or has grown very slowly, in contrast to the impressive growth in two way trade with the United States.

The following table shows the growth of Japanese imports from the four ASEAN countries from 1981 to 1985 (in millions of dollars):

TABLE 8. Japan's Imports from ASEAN
(millions of dollars)

	1981	1985
Indonesia	$13,305	$10,117
Malaysia	2,927	4,309
Philippines	1,731	1,242
Thailand	1,061	1,027

Source: Japan Tariff Association.

Japanese exports to the region decreased during the period. The following table shows Japanese exports to ASEAN countries in 1981 and 1985 (in millions of dollars):

TABLE 9. Japan's Exports to ASEAN
(millions of dollars)

	1981	1985
Indonesia	$4,123	$2,170
Malaysia	2,424	2,167
Philippines	1,928	952
Thailand	2,251	2,030

Source: Japan Tariff Association.

Second, Japan purchases very few manufactured goods from the four countries. A recent analysis of Japanese trade with the ASEAN countries, including Singapore and Brunei, showed that manufactured goods made up 6.4 percent of total exports to Japan versus 48.7 percent of total exports to the United States. 23/

VI. TRADE DISPUTES WITH THE UNITED STATES

As U.S. trade with the four ASEAN countries has grown, trade disputes also have emerged. The four ASEAN governments have voiced concern and criticism over growing protectionist sentiment in the United States, increased

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23/ Smith, Charles. Upset Equations Spark a New Look at Old Problems. Far Eastern Economic Review, June 12, 1986. p. 63.

restrictions imposed by the U.S. Government on their exports, and U.S. subsidies for exports of competitive products. The four governments have cited several product lines in this context:

(1) Tin: Malaysia, Indonesia, and Thailand have complained that the U.S. government's sale of tin under the U.S. Strategic and Critical Materials Stockpiling Act which authorizes the maintenance of the tin stockpile. The releases are authorized in annual defense authorization legislation.

(2) Sugar: U.S. quotas on imported sugar affect the Philippines and Thailand. The President is authorized to impose quotas by the Tariff Schedule of the United States. The quantitative basis for the quotas, however, lies in Title IX of the Agriculture and Food Act of 1981, which sets a requirement for price supports for sugar at specific levels in the domestic market. The decline in world sugar prices prompted the Reagan Administration to impose sugar quotas in 1982. The Philippines has 13.5 percent of the total quota; Thailand has 1.4 percent.

The quota had a harsh impact on Thai sugar exports to the United States, forcing a reduction from 282,000 metric tons in 1981 to 26,000 metric tons for the first quota period, May-December 1982. The U.S. quota has contributed to a decline of Thai sugar exports from nearly 10 percent of total exports in the 1980-82 period to about five percent currently.

The Food Security Act of 1985 directs the Secretary of Agriculture to lower sugar quotas if necessary in order to maintain a domestic price (currently 18 cents per pound) that is well above the world market level. In March 1986, the Agriculture Department used the authority to lengthen the present quota period from 10 to 13 months, in effect reducing the total sugar quota by 23 percent, applied to all countries under the quota. This redution came at a time when the new Philippine government of Corazon Aquino asked that the United States raise the quota for the Philippines as a measure of relief for the depressed sugar industry.

(3) Rice: The Food Security Act of 1985 establishes what Thailand and many other governments describe as subsidies for U.S. exports of rice through the Commodity Credit Corporation's loan programs. These have the effect of setting a price floor for the farmer. The Food Security Act alters the loan programs in the direction of lowering the floor, thus lowering the price the U.S. rice would sell for in the international market.

Thailand has raised the issue with the United States at the highest diplomatic levels. Thai government officials and rice traders believe that U.S. subsidized rice will cut into Thai overseas sales of rice (Thai rice exports are not subsidized). Thai estimates of lost sales due to the U.S. program range from $60 million annually to $200 million. 24/

(4) Textiles: The Thai, Indonesian, and Philippine governments have expressed opposition to legislation (the so-called Jenkins bill) passed in

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24/ Asian Wall Street Journal Weekly. April 28, 1986.

1985 by Congress that would restrict U.S. imports of textiles and garments from Asian countries. President Reagan's veto of that bill was sustained August 6, 1986. Under the bill, Indonesia, the Philippines, and Thailand would have been limited to future growth of one percent per year in each product category of textiles. Malaysia would be allowed generally six percent per year growth, but there would be lower rates for "import sensitive" categories. Most textile exports from Southeast Asia are in the "import sensitive" categories.

U.S. Concerns. The Reagan Administration has pressed these countries to reduce tariff and non-tariff barriers to products from the United States. It has requested that they ratify the Tokyo Round of multilateral trade negotiations under the GATT, which sets up a mechanism for agreements on tariff cuts and elimination of a wide range of non-tariff barriers. The United States has urged ASEAN governments to sign codes of conduct drawn up under the Tokyo Round. Those codes regulate government practices on import licenses, export subsidies, procurement standards, customs valuation, and dumping. The Reagan Administration also has pressed the Philippine and Indonesian government to allow United States banks and insurance companies greater access into their markets for services. Most recently, the administration has pressured Thailand and Indonesia on better protection of the intellectual property rights of United States firms. Both countries have gained a reputation as centers for the production of counterfeit products under United States labels, especially electronic products like video cassettes.

VII. FUTURE ECONOMIC PROSPECTS

For the last 20 years, the economies of Indonesia, Malaysia, Thailand, and the Philippines have retained much of the heritage of dependence on exports of agricultural commodities and natural resources to the Western industrial countries. In varying degrees, they have been successful in diversifying their export product mix to include new commodities and resources, more processed goods, and manufactures. With the Philippines as an exception, this strategy has produced high economic growth and rising living standards for major segments of these nations' populations.

Dependence on the Western industrial countries has produced problems, however, which cloud future prospects: First, world prices for agricultural commodities and natural resources are determined in large part by the levels of demand in the West; recent history has shown wide fluctuations in these prices and a downward spiral since 1979. Second, restrictive policies in the United States, Japan, and Western Europe have limited the exports of certain commodities and, increasingly, manufactured goods. Finally, the debt problem is related in part to the role of the IMF and to the policies of the Western countries affecting interest rates and the position of the U.S. dollar in relation to other currencies.

The outlook for Indonesia, Malaysia, the Philippines, and Thailand is mixed even if generally optimal world economic conditions prevail over the next five years. Philippine recovery is likely to be slow at best, given the magnitude of its problems. Indonesia remains too dependent on oil, and it would be able to take only limited advantage of good opportunities in the world economy. Malaysia and Thailand, however would have good prospects under the right conditions. Their economies have achieved enough diversification so that there are several sectors with strong growth potential.

What are the optimal conditions? The first is political stability. The relationship between political stability and economic performance in these countries is not a simple cause and effect relationship. Each can affect the other in either a positive or negative fashion. In the Philippines, for example, economic decline after 1979 fed growing discontent with the Marcos government. The Aquino assassination in August 1983 produced political instability which, in turn, sparked capital flight and a loss of investor confidence. Since then, political turmoil, growing communist insurgency, and economic decline have fed upon each other, producing a downward spiral in overall internal conditions.

A second optimal condition would be access to foreign capital without aggravating these countries' foreign debt situation. The keys to such access would be increased foreign private investment in these countries, significant economic aid on concessional or grant terms, especially in the case of the Philippines, and a level of interest rates for international borrowers that does not rise and, preferably, would decline further.

Access to major export markets is a third condition. This would involve a reduction of import restrictions by Japan and the Western European countries and at least the maintenance by the United States of the current level of access to the U.S. market. It also would involve strong growth of the Western and Japanese economies and resultant demand expansion.

A growth in demand in the West and Japan also would spur a rise in the long-depressed prices of commodities and natural resources. A similar impact could occur with regard to oil prices. A boost in price levels for these products would have a stimulative effect on the economies of each of the four countries.

The domestic demand of the individual economies long has been a weakness for each of the countries. At times of international recession and falling world prices, domestic demand has been too weak to cushion the impact. This is especially the case today for the Philippines and Indonesia but only slightly less so for Thailand and Malaysia.

The growth of a consumer base in South Korea and Taiwan helped these countries through the 1979-1982 international recession with continued respectable economic growth of four percent per annum or better. Consumer purchasing power was built through a combination of expansion of the agriculture sector, especially in terms of food production; the development of labor intensive industries that exported most of their output; and a broad distribution of income within the agricultural and industrial work forces.

Nevertheless, even in South Korea and Taiwan, domestic purchasing power serves only as a temporary cushion to the effects of a depressed market in the Western countries and Japan. Thus, any alternative strategy of relying on agriculture and the domestic market for economic growth would likely produce only limited results for Indonesia, Malaysia, the Philippines, and Thailand. Growth would be possible but at much lower rates than these countries have achieved since 1970. The same could be said of the economic impact if ASEAN formed a common market. Business opportunities certainly would be enlarged in an expanded Southeast Asian market but not to the extent that would compensate for a major cutback in sales to the West and Japan. Finally, it is doubtful that the Philippines will make an economic recovery in the near term unless the export sector contributes substantially.

CHAPTER 5

PRC MODERNIZATION AND OPENNESS: A NEW LDC AND SOCIALIST MODEL FOR THE PACIFIC*

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IV. THE IMPLICATIONS OF PRC MODERNIZATION FOR THE UNITED STATES, PACIFIC RIM, SOCIALIST COUNTRIES AND LDCS THROUGHOUT THE WORLD..... 117

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I. IMPORTANCE OF PRC MODERNIZATION

Since the death of Mao in 1976, the People's Republic of China has undertaken an ambitious program of modernization. Already, the country has made significant strides in the development of its economic potential but continued progress toward its objectives will require the resolution of a variety of problems in the economic, political, and social spheres. The extent to which China's modernization is carried through and is successful will have an important impact on the country itself, the Asian region, and the world, an impact that may be felt through the following four roles that China could fulfill:

As a Potential Asian and World Economic Power

With human resources comprising one-fifth of the world's population, and a strong energy and material resource base, China possesses formidable potential. With some success in modernization and economic growth, this populous, well endowed country may begin to return to its "Middle Kingdom" status as an economic power, not only in Asia but in the world, fulfilling the traditional (and continuing) Chinese view that China is the center of all culture, power and development in the world.

As a Participant in the Pacific and World Market

With only modest success in modernization and openness, the PRC could become a significant factor in the changing Asian and world market. With substantial success, the PRC could join Japan and the United States as the third major force in the Asian market.

As a Model for Developing Countries

Despite a burden of population unmatched by most other nations in the world, the PRC has been able to develop a growth formula that has taken it out of the shadow of Malthus and put it on the track of dynamic growth; a formula that includes positive control of population and industrialization without urbanization. These characteristics and, in particular, China's ability to feed its own population, are accomplishments that many developing countries could hope to imitate, albeit without the social costs of the "one child" family policy.

As a Model for Socialist Economies

In the context of central Party governance, central planning, and socialist ownership and economic rights, China has moved toward market-simulating efficiency and world quality of output, providing a potentially useful example for other socialist countries. Indeed, all countries that possess a Marxist-Leninist ideology, a centrally planned economy and a centrally controlled system of governance are affected by changes in the PRC. The other Communist giant, the Soviet Union, may be especially influenced as its leaders react to the development of "socialism with Chinese characteristics." Reflecting Soviet interest in Chinese developments, a leading Soviet political observer recently noted, "The economic reforms affecting the management system, the production relations, and each worker in this country with its billion-strong population, are a complex, multifaceted, and highly contradictory process. Time is needed to fully evaluate the results..." 1/ But the Soviet leadership will be watching the process carefully.

Clearly, in each of these four contexts, China could play a significant role. But since China's prospective role in the region and the world may be largely defined by its success in modernization, it is necessary to consider the context in which change is occurring and the various paths China's development might take in proceeding through the rest of the century.

II. THE CONTEXT OF CHANGE IN CHINA: THREE SCENARIOS TO THE YEAR 2000

The economic experience during the Maoist and Deng periods of governance has been more cyclical than stable, alternating between differing sets of central policy objectives. The official modernization program implies a stable trend toward the Year 2000, but the historical record would suggest continuing variations in performance. 2/

Under Deng Xiaoping, China has set forth on a course of ambitious modernization of the economy. In the initial stages, especially in the late 1970s when readjustment and retrenchment were required, the program of modernization and its targets for the end of the century seemed neither credible nor attainable:

- Quadrupling gross value of industrial and agricultural output.
- Tripling personal income.
- Doubling energy output; quadrupling electric power.

1/ Burlatsky, Fedor. Conversations on Economic Reform in China. Literaturnaya Gazeta. June 11, 1986. p. 14. Translated in FBIS Daily Report, USSR International Affairs, June 18, 1986, p. B1-9.

2/ The following discussion draws on the papers in the recent publication of the Joint Economic Committee of the U.S. Congress, China's Economy Looks to the Year 2000: Volume 1, The Four Modernizations, and Volume 2, Economic Openness in Modernizing China, Committee Print, 99th Congress, 2nd Session. Washington, U.S. Government Printing Office, May 21, 1986. [Hereafter referred to by short title, China's Economy I and II.]

However, with rural reform initiated in 1979, urban reform announced in 1984, and the 1985 science and technology reforms to more closely link research with economic requirements, the Chinese are now following a consistent pattern of improved performance--a trend line that could bring them close to the overall targets, which so recently seemed unattainable, by the year 2000. To be sure, a part of this early success represents recovery from the economically disasterous Cultural Revolution under Mao and his radical followers (the "gang of four") and improvements in the abnormally low productivity of China's overcentralized Soviet-style economic system. Still, by introducing extensive and wide-ranging reforms, the Chinese appear to be developing a new form of socialism--a unique mixture of central planning and market forces, referred to as "a socialist system with Chinese characteristics." If successful, these programs for economic development would bring China into the club of major powers, in one of the most rapid economic transitions since the British initiated the industrialization process in the eighteenth century.

One could project any number of possible scenarios for China's economic development but, in this discussion, three distinct paths will be considered--(1) Return to Maoist Political Cycles, (2) Stable Growth Along the Official Dengist Trend Line to the Year 2000, and (3) a Pattern of Variations Around A Trend--the Empirical Record of Restructuring and Reform under Deng. The choice of these scenarios reflects the authors' perception that while Deng's approach to modernization to the year 2000 and the process of economic restructuring and reform represent a potentially new model for China, a return to the pattern of the Maoist period that preceded Deng's introduction of the modernization strategy should not be ruled out.

There are, however, various points of view on other putative scenarios deriving from disagreements on how the pre-Deng period should be characterized and how the future prospects for China's economy should be defined. According to the Soviet commentator, Burlatsky, the Chinese recognize the existence of the five socialist economic models that might be considered frames of reference: the Soviet period of war communism; the Soviet economic system of the 1930s; the current Soviet approach; the Hungarian approach; and the Yugoslav model. 3/ In the Chinese analysis, Deng's reforms are characteristically referred to as a change from the Soviet model; many Western observers such as Robert Dernberger also characterize the pre-Deng period as one of adherence to the Soviet model. 4/ Nevertheless, it can be argued that the Chinese experience, while perhaps somewhat Stalinist in form, was not Stalinist in substance. Therefore, the period preceding 1976 could be referred to as a

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3/ Burlatsky, Conversations, p. B-8.

4/ Dernberger, Robert F. Economic Policy and Performance. In China's Economy I. p. 15-48.

Maoist period--reflecting a distinctly Chinese approach to development. 5/ Given the latter interpretation of the past, one cannot preclude a scenario of return to the general dominance of political-ideological factors over economic growth and efficiency.

A Return to Maoist Political Cycles. There have been times such as the Great Leap Forward and the Cultural Revolution periods when the requirement for ideological revitalization conflicted with policies for economic performance. If this experience is repeated periodically, stable long-term growth prospects would be in jeopardy. To assume that there will be no recurrence of these economically disturbing political-ideological cycles would, on the one hand, give very great weight to the unique force of Mao's personality and, on the other hand, deemphasize the broader base of support in the Party and nation as a whole for the "Yenan" revolutionary spirit, support which Mao must have had.

Thus, a return to Maoist political cycles must be considered one possible path for China's future development. Still, as time goes on, the cost of a return to Maoist strategy and tactics becomes greater in political and economic terms:

- o Return to the commune and egalitarianism in agriculture.
- o Return to more centralization, mandatory planning in industry and extensive development of the economy;
- o Return to ideological-political training for political and economic cadres, deemphasizing technical education.
- o Deemphasis on acquiring Western technical and managerial expertise.
- o Return to mass army, guerrilla strategy for military formations and political-ideological strategy abroad.
- o Return to autarky in foreign commerce and self reliance.

The following table (Table 1, page 5) illustrates the cycles of economic development experienced by the PRC under Mao and in the first five years following his death. As indicated by the figures, economic growth occurred in the periods of rehabilitation and the first five-year plan, but implementation of the economic policies of the Great Leap Forward led to drastic reversals, with GNP in 1961 dropping to the levels of 1953-54. The economy began to recover and move forward again during the period of readjustment and recovery; however, during the Cultural Revolution of the late 1960s political and ideological objectives superseded economic goals, as reflected in the relevant declining production figures, especially during 1967 and 1968. Since 1970, the indicators show generally steady improvement and growth in China's economy.

5/ For a more detailed discussion of China's development in comparison with the U.S.S.R., see Hardt, John P. Economic Reform in the PRC, Soviet Union and East Europe: Comparative Themes Toward the Year 2000. Issues and Studies. Taipei, The Institute of International Affairs, December 1986.

TABLE 1.—CHINA: MAJOR ECONOMIC INDICATORS, 1949-80 [REV. AUG. 14, 1981]

Period	GNP (billions of 1980 dollars)	Population midyear (millions)	Population increase (percent)	GNP per capita (1980 dollars)	Agricultural production (1957=100)	Grain output (millions of metric tons)	Grain output per capita (kilograms)	Industrial production (1957=100)	Steel output (millions of metric tons)	Coal output (millions of metric tons)	Oil output (millions of barrels per day)	Percent trade with Communist countries
1949-52: Rehabilitation:												
1949	71	538	------------	131	53	111	205	20	0.16	32.4	0.002	Negligible
1950	86	547	1.77	158	64	130	235	27	.61	42.9	.004	29
1951	100	558	1.95	179	72	141	250	38	.90	53.1	.006	51
1952	118	570	2.11	206	84	161	280	48	1.35	66.5	.009	70
1953-57: 1st 5-yr plan:												
1953	123	583	2.23	211	84	164	278	61	1.77	69.7	.012	68
1954	127	597	2.42	213	84	166	275	70	2.22	83.7	.016	74
1955	140	612	2.50	229	94	180	291	73	2.85	98.3	.019	74
1956	150	626	2.40	240	97	188	297	88	4.46	110.4	.023	66
1957	159	642	2.46	248	100	191	294	100	5.35	130.7	.029	64
1958-60: Great leap forward:												
1958	180	658	2.46	274	103	196	295	142	11.08	230.0	.015	63
1959	170	672	2.25	253	83	171	252	173	13.86	300.0	.074	69
1960	156	682	1.38	228	67	141	206	181	18.66	280.0	.10	66
1961-65: Readjustment and recovery:												
1961	125	682	.01	183	69	146	215	105	8	170.0	.11	56
1962	140	682	.00	205	79	163	238	111	8	(1)	.12	53
1963	158	692	1.53	228	86	175	250	134	8	(1)	.13	45
1964	182	712	2.93	256	98	154	268	161	9.6	214.0	.18	34
1965	203	736	3.33	276	101	194	260	199	12.2	232.2	.23	30
1966-70: 3d 5-yr plan:												
1966	232	759	3.04	306	114	220	286	232	15	271.4	.29	26
1967	226	780	2.86	290	120	230	291	202	10	190.0	.28	21
1968	228	802	2.79	285	115	221	272	221	9	235.8	.30	22
1969	252	825	2.87	305	119	230	275	266	16	281.6	.43	20
1970	282	848	2.82	333	126	243	283	316	17.8	327.4	.60	20
1971-75: 4th 5-yr plan:												
1971	301	871	2.64	345	130	246	279	349	21	353.6	.77	23
1972	312	892	2.40	350	126	240	266	385	23	376.5	.90	21
1973	351	912	2.23	385	141	265	288	436	25	398.1	1.14	17
1974	364	931	2.14	391	146	275	292	455	21	403.0	1.36	17
1975	388	950	2.01	408	148	284	296	502	24	478.0	1.54	16
1976-80: 5th 5-yr plan:												
1976	395	967	1.79	408	152	286	293	508	20.5	483.0	1.74	18
1977	429	982	1.60	437	155	283	286	581	23.7	550.0	1.87	16
1978	479	997	1.53	480	169	305	303	659	31.8	618.0	2.08	14
1979	520	1,012	1.50	513	183	332	326	716	34.5	635.0	2.12	12
1980	552	1,027	1.46	538	188	320	309	778	37.1	620.0	2.12	12

[1] Not available.

Ashbrook, Arthur. China: Economic Modernization and Long-Term Performance. In U.S. Congress. Joint Economic Committee. China Under the Four Modernizations, Part I. Washington, U.S. Govt. Print, Off., August 13, 1982.

Stable Growth Along the Official Dengist Trend Line to the Year 2000. In contrast to a return of Maoist cycles, a second scenario could project a stable trend of development to the year 2000, as anticipated in Deng's modernization program. Such a steady, irreversible improvement in performance has been the only scenario entertained publicly by the Chinese. Given their exclusive focus on this path of growth, it should be included here as one possible outcome for China's economy over the rest of the century. Indeed, some of the past achievements of the Chinese in economic development may suggest that such an optimistic trend would not be impossible to accomplish.

Even prior to Deng's modernizations, some of the industrial accomplishments of Mao's China were impressive. Industrial growth, although variable, has been significant since the Communists took power in 1949. Effective restructuring and reform in rural China may be carried over to the urban economy. Already significant deregulation of the centrally controlled sectors and widespread introduction of incentive systems has brought about some promise of improved economic performance and this trend may continue.

- Decentralization may substitute local for central control; self-initiative for directed management; profit-seeking innovation and retention of profits from the market for material balance planning.

- Prices may become flexible and responsive to relative scarcity.

- The traditional zero price attached to investment--a major departure from scarcity pricing--may give way to interest bearing loans to promote new projects and user taxes to reflect the scarcity value of existing resources.

In addition to these measures, a shift from extensive to intensive development in China--coincident with economic reform and restructuring of the economy--would be necessary to ensure a steady continuation of the growth trend. Reform of the Chinese economy has been viewed as necessary to overcome avoidable waste, central planning inconsistencies, and excessive regulation that has impeded cost reduction and mobility, and lack of planning coordination that has led to significant cost increases. Furthermore, intensification would address the problems of the Maoist past in which there was little incentive to value costs accurately and to increase quality; innovation was absent from the Chinese economy except for specific priority sectors.

These are ambitious requirements to meet and there are those who feel that market simulating improvement in efficiency is impossible for a centrally planned economy without the abandonment of central control and adoption of a fully pluralistic market system. Due to this incompatibility of central planning and the market mechanism they argue that halfway reform measures could lead to "retrogression toward some form of modernized Stalinist administrative command" system. 6/

6/ See Prybyla, Jan S. Mainland China and Hungary: To Market, To Market. . . . and Cheng, Chung-Yuan. Economic Reform in Mainland China: Consequences and Prospects. Issues and Studies. Taipei, The Institute of International Affairs, December 1986.

Dengist Variations around a Trend: Continuation of Incremental Remedial Restructuring and Reform Under Deng. The third, and perhaps most likely, scenario reflects the empirical record of variations around a trend in which progress toward growth and modernization has been both muted by setbacks and adjustments and stimulated by above plan performance, but not reversed. Although the PRC's post-Mao economic success has been notable to date, it would be even more remarkable if the growth continued on a straight line, unabated to the year 2000. These official Chinese projections are the basis of World Bank projections to the year 2000. More likely seems to be a range of outcomes around the official projections. Professor Lawrence Lau, with a more conservative view on agricultural performance and Albert Keidel, et al. at Rock Creek Research, provide such a range of aggregate and sectoral projections (Table 2, below).

TABLE 2. Comparison of Real GDP Growth Projections, 1981-2000

	Agriculture	Industry	Other	Total
World Bank Quadruple	4.9	7.1	7.6	6.6
L. Lau High Scenario	3.4	7.9	6.7	6.7
Rock Creek Research Low	5.7	7.7	9.3	7.8
Rock Creek Research High	5.7	9.3	9.8	8.7

Sources: World Bank. China: Long-Term Issues and Options. The Main Report, no. 5206CHA, East Asia and Pacific Regional Office, May 1985. L. Lau. A Model of the Chinese Economy, unpublished, 1985. Albert Keidel, Robert Bruce, Nicole Carter, Rosemary Draper. The Role of Technology Transfer for China's Economic Future, prepared for the Office of Technology Assessment, United States Congress, May 1986, Rock Creek Research, Inc. p. 2.

In considering what may occur in the future, it is necessary to consider both the positive and negative aspects of China's past and its likely future experience. While the Chinese are reluctant to acknowledge the continuing need for unplanned and unpredictable adjustments and restructuring, bottlenecks in certain key sectors and a variety of potential problems, including possible conflict between the imperatives of economic reform and the imperatives of the Marxist political system (to be discussed below) are likely to cause variations in performance and deviation from the steady trend. These variations from the planned trend line may lead to performance not only below the projected levels but at times, above the projected levels. For example, recent growth has been deemed too rapid as it generated inflationary and balance-of-payments problems. This has, in fact, been the pattern of change and development under Deng to date; the third scenario would thus appear the most likely as we reflect on this history of variability in performance and results.

Of course, a fourth possibility must be acknowledged--that continued reforms do not bring about any improvement in performance and that China's growth simply retards, without reversal to the political swings of Maoism. However, in looking at the dynamics of Chinese growth and development to date under Deng's modernization programs, there appears to be both the momentum and potential for continued economic growth in the future, albeit with occasional setbacks and readjustments.

Many Western specialists on the Chinese economy accept the likelihood of substantial growth to the year 2000. The range of estimates between Keidel (more rapid growth) and Lau (somewhat slower growth) appears to embrace most of the Western estimates. It is our view, as reflected in scenario three, that although continued growth is likely to occur, steady growth is as unlikely in the future as in the Dengist past. The ability of the leadership and economic decision makers to overcome bottlenecks, identify and effectively react to constraints on performance, and take the necessary steps to adjust, consolidate, improve and reform will determine the level and quality of performance. These policy adjustments may be in some cases predictable, as are policy or economic cycles elsewhere. For this reason, economic indicators might be designed for providing evidence of emerging problems in areas that are likely to constrain growth. These explicit indicators of progress and setbacks would be helpful for Chinese leaders and Western observers alike, since the Chinese ability to recognize and deal with these "growing pains" of development and willingness to address the potentially far-reaching political and ideological implications of reform will determine both the level of China's future performance and the character of fluctuations in performance. This pattern of variations in performance is the focus of our discussion of "Deng's Record to Date" which follows.

III. PRAGMATIC RESTRUCTURING AND REFORM: DENG'S RECORD TO DATE

If scenario three is the most likely path for China's future economic development, one can find in the record of Deng's reforms to date the underlying factors of growth that will create variations both above and below the leadership's projected trend. In each of the four modernizations and the opening of the economy, the areas of success and obstacles to full implementation of reform can be seen.

A. Rural Reform and Agricultural Modernization

1. Population Prospects: Consumption and Employment

China's "One Child Policy" and its recent population trends raise the prospect of a reduced population growth rate, one that could be sustained both by increasing labor force utilization and expanding consumption, i.e., full employment and rising real income. 7/

The most populous country in the world--its one billion people represent more than one-fifth of the world's population--China has shifted its population policy in the last decade from the Maoist view that more people are an asset to a belief that unrestricted growth of its population would be a severe economic burden. General health indicators have been comparable to those of many more economically advanced economies, showing increased life expectancy, reduced infant mortality, and decline of infections and specific diseases. With a turn to population control during the last decade, and through a variety of incentives and often stiff penalties, Chinese authorities managed to lower birth rates from over 30 per 1,000 in 1971, to 18 per 1,000 in 1979 [from 2.3 to 1.2 percent natural growth per annum]--an astonishing reduction in natural increase. To maintain these levels of fertility despite a significant increase in the number of young people in the reproductive ages--and as part of a long-term demographic strategy to achieve a stable population of 1.2 to 1.4 billion--China has been pressuring couples to have just one child.

Even with a lower rate of population growth, there will still be the need to create some half billion new jobs by the early 21st century in order to maintain an acceptable unemployment rate of 5 percent or less. The traditional right to work has been challenged by this acknowledged unemployment rate. Taking into consideration both concealed unemployment and underemployment, urban unemployment may be as high as 10-15 percent, or several times the official rate. China's industrial labor force may now be larger than the total industrial labor force of all developing economies combined. Once unevenly industrialized with major assets concentrated in Manchuria and the coastal areas, China is now in the process of dispersing industry and transport throughout the country, contributing to the development of a national economy.

7/ See articles by Lardy, Nicholas R. Overview: Agricultural Reform and Rural Economy; Crook, Frederick W. The Reform of the Commune System and the Rise of the Township-Collective-Household System; Orleans, Leo A. Overview: China's Human Resources; Aird, John S. Coercion in Family Planning: Causes, Methods, and Consequences. Taylor, Jeffrey R. Labor Force Developments in the People's Republic of China, 1952-83; Banister, Judith. Implications of China's 1982 Census Results; Eberstadt, Nick. Material Poverty in the People's Republic of China in International Perspective; Surls, Frederic M. China's Agriculture in the Eighties; Travers, Lee. Peasant Non-Agricultural Production in the People's Republic of China; Lampton, David M. Water Politics and Economic Change in China; Sicular, Terry. Recent Agricultural Price Policies and Their Effects: The Case of Shandong; Hanson, Jaydee R. Chinese Fisheries; Stone, Bruce. Chinese Fertilizer Application in the 1980s and 1990s: Issues of Growth, Balance, Allocation, Efficiency, and Response. In China's Economy, I.

In the final analysis, the level of China's unemployment and underemployment will depend on the management of the countryside. The goal is to increase non-agricultural activities in the rural areas, develop small and medium-sized towns, limit the proportion of laborers involved in crop cultivation, and, of course, increase productivity.

Although Maoist economic policy did not again intervene massively in the rural economy after the end of the Great Leap Forward period of forced commune development (1958-60), agricultural performance did not increase markedly before the introduction of rural reform. In 1978 China was still dependent on imports to feed its population despite technological advancements in seeds, fertilizer, and water use. Moreover, roughly 40 percent of the urban population in 1978 depended on imported cereals and even a larger proportion was dependent on non-grain imports; in fact, China was one of the world's largest importers of edible vegetable oils and raw cotton. In addition, rural income increased only very modestly in the two decades from 1956 to 1978 as modern inputs into agriculture were offset by the adverse effects of the rising man-land ratio. Systemic inefficiencies generated by the emphasis on local self-sufficiency, and the curtailment of rural marketing that precluded efficient matching of agricultural supply and urban demand contributed most to the retardation of effective rural growth.

The most notable achievements of Deng's modernizations to date have followed the introduction of rural reform in 1978 when the 800 million people in the countryside, previously organized in egalitarian communes, began a shift to a family responsibility system. 8/ Not only did output in grain and basic necessities, such as cotton fiber, increase, but rural industry burgeoned, representing now 10 percent of total industrial output and employing 20 percent of the rural labor force. The successful expansion of food production and the implementation of population control programs have permitted the world's largest nation to escape the specter of Malthus and become an exporter of foods. Personal income and rural output increases during the rural reform period have been impressive:

- Peasant income has doubled in less than a decade; per capita farm income rose from 134 to 310 Yuan during the years 1978-1983. Increased rural income resulted in a sharp rise in peasant consumption and private housing construction. The sharply differentiated incentive system has changed not only land tenure but the social structure of rural China.

- From 1978-84, grain production grew 4.9 percent as compared to only 2.1 from 1957-78.

- Output of other crops grew still more rapidly as China became a net exporter of coarse grains, soybeans and raw cotton.

8/ Communique of the Third Plenary Session of the 11th Central Committee of the Communist Party of China, adopted on December 23, 1978. Translated in FBIS Daily Report, PRC National Affairs, December 26, 1978, p. E4-13.

These increases were accomplished without a significant burden on centrally planned investment. While state investment in agriculture decreased, the use of rural credit went up. Moreover, increased output was produced on reduced acreage in cultivated farmland through more efficient use of existing resources--in part a result of increased incentives inherent in the family responsibility system. The national self-sufficiency of China, indeed the development of an agricultural export capability, is a major accomplishment; it is of global importance that the PRC, with one-fifth of the world's population, is no longer a burden on world food resources.

While by key per capita income measures China still ranks near the bottom among developing countries, viewed in the historical perspective Chinese human resources are being well used and served in their development process. As the Chinese economy has grown, so have Chinese consumers' expectations--from the income level typical of a developing country where workers and peasants alike worked to buy bicycles, watches, sewing machines and radios, to the current expectation of successful peasants and workers for consumer durable goods, such as motorcycles, refrigerators, and television sets. China's successes in rural development were highlighted by the Soviet political commentator Fedor Burlatsky as follows:

> First and foremost--transition to contractual responsibility. Contracts within the framework of the family, cooperative, rural industrial enterprise, or trade association. Second--orientation toward diversified agricultural production, and also expansion of stock raising, vegetable growing, and industrial crops. Third--fast growth of small and medium industrial production in the countryside.
>
> And finally--and this process is only just beginning--utilization of modern scientific achievements, particularly in the sphere of horticulture and fertilizers. 9/

2. Trends and Problems: Inadequate Infrastructure to Support Growth and Insufficient Consumer Goods to Absorb Purchasing Power

The implementation of wider local autonomy in the agricultural and rural economy may be sufficient to sustain growth if the rural infrastructure, including transport, does not become a major constraint. The rural reform may be divided into two steps: (1) initial family responsibility, local production stage, with incentives from a split market; (2) secondary infrastructure building, expansion of consumption, and income differentiation stage. In this secondary stage, perhaps in the

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9/ Burlatsky, Conversations, p. B2-3.

1990s, bottlenecks may arise with diminished returns to inputs, slowing real growth.

- Long-term increases in agricultural output and productivity, albeit difficult, may be sustained through continued incentive effects of decollectivizing land holdings; increased specialization and marketization; continued stimulation from increases in key modern inputs--e.g., mineral fertilizer. However, each of these important sources of past growth in productivity may have diminishing effects in the future.

- Success in rural production will make more important the necessary improvement in the underdeveloped rural infrastructure and marketing systems. Incentives to facilitate marketing are urgently needed--development of rural infrastructure, inland waterways, water supply, power generation, rural road network, storage, refrigeration, and food processing may all be significant for continued improvement in productivity.

- Effectively joining increased supplies in rich rural provinces with demand in urban and other less productive provincial areas will be a challenging, complex process of transport development.

There are at least two schools of thought on continued potential in the Chinese rural economy: One school argues that improvements in the future must come from outside the rural economy; i.e., rural gains have been largely exhausted; now increased state investment is needed to improve transport marketing networks and other ties to the national economy. The other view suggests that improvements in performance are still possible inside the rural economy and financing may come from reinvestment by rural collectives and peasant households. Accurate components probably exist in both analyses.

B. Urban Reform and Industrial Modernization 10/

Urban reform and industrial modernization may require both effective decentralization and selective centralization, an apparent contradiction that will have to be resolved for success in the long-term.

10/ See articles by Barnett, A. Doak. China's Modernization: Development and Reform in the 1980s; Dernberger, Robert F. Economic Policy and Performance; Carver, Dean. China's Experiment with Fiscal and Monetary Policy; Halpern, Nina. Making Economic Policy: The Influence of Economists; Rawski, Thomas G. Overview: Industry and Transport; Field, Robert Michael. China: The Changing Structure of Industry; Naughton, Barry. Finance and Planning Reforms in Industry; Fischer, William A. Chinese Industrial Management: Outlook for the Eighties; Wong, Christine P.W. Ownership and Control in Chinese Industry: The Maoist Legacy and Prospects for the 1980s; Walder, Andrew G. The Informal Dimension of Enterprise Financial Reforms; in China's Economy, I. See also Fingar, Thomas. Overview: Energy in China; Brown, William B. China: Energy and Economic Growth; Keidel, Albert. China's Coal Industry; Suttmeier, Richard P. China's Nuclear Power Option; Lewek, Jim. China's Electric Power Industry; and Bosco, Don M. China's Hydropower Development. In China's Economy, II.

1. Guidance Planning and Profitability [11]

The process of change from central, mandatory planning toward local autonomy and financial-monetary planning may proceed through stages of delegation of responsibility and independence using analogues and surrogates of market measures.

- Urban reform with its shift from mandatory to guidance planning is more complex than rural reform; the key to effective decentralization is a good profitability measure: one based on prices and costs which reflect relative scarcity and on interest rates and taxes which respond to market forces.

- Shift of decision-making power from the center to enterprises and from the planning bureaucracy to professional managers may be politically easier now while Deng has broad-based support for reform, but, without the concomitant development of rational prices, interest rates and other monetary measures necessary to determine profitability, it will be difficult to evaluate success under guidance planning.

The balance between central planning and local autonomy in urban reform to date has been described by the Chinese:

> The most important commodities which are in short supply, like steel, copper, and cement, will be distributed by the state like before, even though a certain proportion of them is already available on the market. For example, we distribute centrally 80 percent of steel, but only 20 percent of cement. The ultimate aim is that all materials, including the ones in short supply (with the exception, of course, of the military industry sphere), will be distributed via the market....
>
> The reform now affects basically the medium and small enterprises, which are introducing a system of responsibility in various forms. Furthermore, extensive rights have been given to provinces, districts, and cities. And probably the most important aspect is the fact that we have embarked on the transition from deductions from profits to tax collection. The tax at present is equal to approximately 50 percent of net profits. This means that the remainder of the profit stays with

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[11] See the Decision of the 3rd Plenum of the 12th Party Central Committee adopted October 20, 1984. Translated in FBIS Daily Report, PRC National Affairs, October 22, 1984, p. K1-20.

> the enterprises which use it for technical reconstruction, wage increases, the building of housing and of children's and cultural institutions, and also as a bonus fund. 12/

2. Central Planning for Energy and Transportation

While decentralization reforms could bring positive results in agriculture and industry, lack of full central control may be a disadvantage in developing and implementing comprehensive energy and transport programs.

China has experienced energy shortages, though these shortfalls have not been for lack of natural resources. Richly endowed in oil, gas, coal and hydro, China has the resource capability to provide for its own needs and become a major exporter of energy. Development of nuclear electric power potential may help resolve China's regional electric power supply and demand inequities; but energy output and supply have fallen far short of the needs and potential, making energy the pervasive bottleneck for meeting macro- and microeconomic goals.

Early post-Mao optimism on energy sufficiency gave way to a policy of readjustment, reform, consolidation, and improvement [the eight character policy], designed to alleviate energy deficiencies. To meet the leadership's target of quadrupling the gross value of industrial and agricultural output by the year 2000, a doubling of total energy and a four-fold increase in electric power production will be required. Continued central planning and control may be needed to provide the necessary investment for expansion of programs in energy and transportation:

- o Continued centralized, mandatory planning in critical sectors such as energy, transportation, and defense, may restrict development of guidance planning. Incremental changes may be effectively made, but the assurance of success through partial reform is currently lacking.
- o Central planning appears to be imperative in comprehensive development of hydrocarbons, hydro and nuclear power and transmission networks; local investment increases may be largely adequate to develop coal mining supplies.
- o Key energy projects may be given special priority and access in order to assure adequate supplies of foreign exchange and imported technology. Foreign funds are especially important for long-term, large scale oil and hydro programs.

12/ Burlatsky, Conversations, p. B6.

- o Overall comprehensive plans for coordinated development of hydro, thermal and nuclear capacity are needed but not yet developed to meet ambitious electric power goals. Investment debates pitting transmission against fuel transport requirements are likely, especially in decisions on coal and hydro programs (e.g., whether generating capacity should be located at energy source or demand center). Advocates of nuclear power tend to argue for locating of nuclear power stations at the demand or load center. Supply of nuclear reactors, especially from the United States, will have to comply with nuclear nonproliferation agreements.

- o Petroleum prospects may be constrained by lack of success in attracting foreign investment for expansion of offshore and interior-based oil production; by inadequate advanced technology to improve recovery rates at old wells; and by inadequate modern equipment to improve efficiency throughout reservoir exploitation.

- o Energy conservation and restructuring of energy balance is likely to be necessary, with particular focus on reducing oil consumption. Shift in priority from heavy to light industry is currently helpful in reducing energy needs but is not a long term solution.

C. Science and Technology Reform and Modernization [13]

Science and technology is to play a key role in modernization; the new industrial electronic revolution of the Western and Japanese industrial economies will both enhance China's modernization and increase the severity of competitive challenge. Therefore, it is deemed necessary (though not sufficient) to plan for the transition from extensive to intensive growth. The reform of science and technology may be formally associated with a March 1985 decree in which the need for a "technology policy" was announced in order to provide a more effective organization for scientific and research development, better use of foreign technology and improved cadres. [14]

1. Organizational Changes Necessary but Not Sufficient

The restructuring and reform of the scientific and research community is necessary but may not be sufficient to create the dynamic environment needed by the year 2000. The following changes will need attention:

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[13] See articles by Suttmeier, Richard P. Overview: Science and Technology under Reform; Rehn, Detlef. China's Computer Industry at the Turning Point; Battat, Joseph Y. Transfer of Computer and Data Processing Technologies: First-Hand Experiences of a Foreign Consultant; Simon, Denis Fred. The Evolving Role of Technology Transfer in China's Modernization; and Lubman, Stanley B. Technology Transfer in China: Policies, Practice and Law. In China's Economy, II.

[14] Decision on the Reform of the Science and Technology Management System, Central Committee of the Communist Party, March 13, 1985. Translated in Beijing Review, No. 14 (April 8, 1985), p. 19-21.

- Early benefits of the closer marriage of research and production should be continued and expanded; otherwise, scientific and technological reform may be of short duration and limited impact.
- New incentive systems will need to be continuously supported with greater effort and sacrifice to keep up the momentum toward a dynamic and innovative scientific and technological environment.
- The disconnection between research and production will need to be overcome.
- The quality and relevance of technical and scientific research needs to be improved.

Recent changes in research funding are intended to provide incentive systems that will help stimulate R & D through change from central and institutional funding to the development of contract research mechanisms and project choice based on peer group review. Production and research managers alike must learn to reduce risk aversion--because of conservatism and lack of incentives, the Chinese system of S & T has been wasteful, rigid, and not as productive as it could be.

China has developed complex and expanding ties with the international technical community and has introduced new approaches to R & D. The strategy for S & T modernization has been to simultaneously treat the five institutional parts of China's research system: the Academy of Sciences, Institutions of Higher Education, production ministries, national defense research institutions and local science and technology departments. The separation of these institutions currently acts as an impediment to development; improved communication and stimulation are needed to create a dynamic environment. The establishment of super-ministries may help to coordinate S & T at the top but, since local participants possess 80% of the resources needed to stimulate modernization, increased communication must be fostered at the local level as well.

2. Better Use of Foreign Technology

Expanded imports of Western technology and increased contact with the international scientific community could raise additional issues that will have to be resolved. Western imports of science and technology may have a serious impact on the Chinese political system; modern, dynamic science and technology has an inherently pluralizing effect on a controlled political system. Specific problems in transfer of technology such as patent copyrights and systems must be addressed as well.

3. Improved Scientific Cadres

It is important to develop a sufficient scientific and technical manpower pool within the new generation of Chinese students. Unlike the previous generation which was sent to the work bench and commune during the Cultural Revolution, the new generation finds itself in the throes of an explosion of educational opportunities as well as uncertainties. Pragmatic training as scientists, engineers, and managers has replaced the ideological requirements as the foremost prerequisite for success; the achievements of Chinese youths will now be measured in considerable part by their ability to effectively adopt Western methods and adapt them to Chinese needs.

Thus, to a large extent, scientific and technological modernization will depend on effective reforms in the advanced educational system which, in turn, will help determine how wide the opening to the West must be. Already, the modernization of science and technology has led China to reach abroad with the presence of over 12,000 Chinese students in U.S. higher educational institutions. Although the current system is elitist, it does provide upward mobility, even for rural youth. Equality of opportunity has explicitly replaced equality of reward, although differentiation in the social system and change in the political culture may go beyond the bounds of what is acceptable to future leaders.

D. Military Modernization: The Fourth Modernization 15/

Modernization of the military is underway as well, but remains the fourth modernization. The continued low priority of military modernization is in tune with the generally non-military character of the non-Communist, Pacific region. Thus "guns" are characteristically submerged to the claims of "growth" and "butter" in the reorganization and restructuring in Chinese military modernization.

1. Reorganization of the Chinese Defense Support Establishment

- The short-term objectives of defense modernization are aimed at improvement in combat readiness of forces through adaptation of combined arms operations; improvement in the technical and professional skills of the officer corps; and creation of monetary incentives keyed to improved professional performance.

- The long-term objectives may be served by improvement in the scientific and technical base, making it capable of developing and producing weapons based on modern technology; and by the development and deployment of strategic systems which provide a more credible nuclear deterrent.

PRC military expenditures are exceeded only by those of the U.S. and U.S.S.R. and the Chinese defense industrial base is among the world's largest; nevertheless, the burden of defense has not offset or seriously retarded civilian modernization. Defense allocations have not increased

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15/ See articles by Godwin, Paul H.B. Overview: China's Defense Modernization; Parris, Ed. Chinese Defense Expenditures, 1967-83; Sutter, Robert G. Chinese Nuclear Weapons and American Interests--Conflicting Policy Choices; and Dreyer, June Teufel. The Role of the Military in the Chinese Economy. In China's Economy, II.

appreciably since 1972, except for a modest increase to fund the Vietnam invasion of 1979. Still, military modernization will in time represent a major overhaul of the defense establishment. Although some external assistance will be needed, the primary objective is to develop a self-sustaining defense infrastructure.

2. Military Manpower and Readiness

The traditional multi-functional role of the armed forces in the Chinese economy and society has been maintained with continuing attention to its symbolism, even when the substance of resources for priority modernization has been lacking. Upgraded military modernization always threatens other modernization efforts:

- Growth needs may create hard choices in military modernization, particularly if the external threat increases and the security requirements are upgraded.
- Perceived threats or opportunities in the external environment, e.g., in dealing with the Soviet Union, Vietnam or Taiwan, may lead Chinese leaders to upgrade military modernization, a development which would tend to generate further threats within the region in an escalating process.

3. Military Reform in the Regional Context

PRC defense modernization presents opportunities and risks for U.S. interests:

- Offsetting the increases in Soviet power in Asia is consistent with U.S. interests.
- However, the Chinese might use political-military power in Asia at the expense of U.S. interests, raising the threat, for example, of a forceful solution to the Taiwan question.

E. Openness of the Economy to the World Market 16/

China is becoming involved in the international economy at an unprecedented rate, opening its economy in a fashion unparalleled by the development of any

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16/ See articles by Woodcock, Leonard. Overview; Davie, John L. China's International Trade and Finance; Noyes, Helen Louise. United States-China Trade; Falkenheim, Victor C. China's Special Economic Zones; Sutter, Robert G. Hong Kong's Future and Its Implications for the United States; Pelzman, Joseph. PRC Textile Trade and Investment: Impact of the U.S.-PRC Bilateral Textile Agreements, and Economic Advantages to the PRC From Access to the U.S. Generalized System of Preferences; Lubman, Stanley B. Equity Joint Ventures in China: New Legal Framework, Continuing Questions; Nanto, Dick K. and Kim, Hong Nack. Sino-Japanese Economic Relations; and Copper, John F. China's Foreign Aid Program: An Analysis and Update. In *China's Economy*, II.

other Communist country. As recently as 1970 the People's Republic of China was isolated from the global economy. In the 1980s, having abandoned its policy of autarky, China is opening its economy and society to spur modernization. Over its long history, China has been opened many times from the outside by West Europeans, Americans, Japanese, and Soviets interested in extending their sovereignty and expanding their trade. Now, under Deng Xiaoping, China is pursuing at least temporary interdependence with the developed Western economies on its own initiative and has invited in foreign economic and technical influence to help revolutionize its economic system and broaden accommodation with the global economy.

Seeking to become a major trading country in the Pacific, China has set a goal of tripling its trade with the United States. Moreover, China supplies modest economic aid and influence throughout the Third World, projecting its role as the largest socialist and developing country. By its success in selective emulation of the developed Western economies, China provides an effective role model to all the developing countries.

1. Role of SEZ - A Step Toward Openness

The Special Economic Zones (SEZ) created in the PRC have provided the meeting place for the centrally-planned, developing Chinese economy and the market economies of the developed West. Joint ventures, Western legal systems, Western management, and Western technology have not only been permitted into China but embraced. In this way, one of the world's oldest, most traditional societies has sought and successfully absorbed, in a relatively short time, important aspects of Western political-economic culture. Reflecting this dramatic change in Chinese openness to Western economic influences is the slogan of Shenzhen, the most advanced SEZ--"Time is money, efficiency is life."

2. Balance of Payment Constraints on Commerce

The People's Republic of China is projected to become a major actor in the Pacific region and in the global economy. However, rapid expansion of foreign commercial relations in the post-Mao period has led to periodic retrenchment, sharp cutbacks and adjustments. As a result, China's opening to and absorption in the world market have so far been uneven. Commercial growth projections are subject to a variety of tenuous assumptions and considerations:

- Long-term growth in commercial relations is tied to the Chinese ability to export--especially hard currency-earning sales of offshore oil.

- Ineffective industrial accommodation to joint ventures has restrained the absorption of foreign technology, especially transfer through the Special Zones to domestic economy. Foreign intervention in domestic Chinese decision-making may not prove to be in Chinese interests and may revive latent xenophobia.

- Substantial credit potential and full use of the foreign direct investment inherent in close commercial ties has not been forthcoming.

Nevertheless, China's modernization and its opening to the world economy offer opportunities and challenges to the United States; U.S. policies may promote or impede PRC developments:

- Diversification and expansion of global Chinese commercial relations is a part of an overall normalization process with East and West. A shift in the structure of trade from material exports to machinery, in time, is the Chinese objective.
- Japan has advantages of geographic proximity and cultural affinity to reinforce natural economic fit. Aggressive Japanese promotion strengthens this natural advantage.
- A major economic turning point in U.S.-PRC trade is tied South China Sea oil development.
- Textiles will continue to be a key export of China and threaten U.S. industry but may be a manageable problem area with U.S., especially with an amicable settlement of disagreement over the General Agreement on Tariffs and Trade (GATT), the Multifiber Agreement (MFA) and continued extension of Generalized System of Preferences (GSP).

Chinese leaders envision the PRC becoming a major trading country in the Pacific. If they are successful, the Chinese market would cease to be the mirage of the past and live up to its long-term promise. At the same time, development of Chinese economic power would permit China to exercise influence over political, military and economic affairs in Asia and throughout the world, a role that would not necessarily be consonant with U.S. interests.

3. Reaction and Resistance to Openness

While foreign technology and technicians aid modernization and generate exports, they also compete with and replace elements of the domestic economy in an uneven pattern. Negative effects of openness and renewed xenophobia may lead to retrenchment and revision of openness.

F. Assumptions Underlying Continued Reform and Growth

Having highlighted (with the assistance of the new study of China's economy) the achievements of and obstacles to Deng's four modernizations and opening of the economy, what is the likely path of China's economic development during the rest of the century? China's experience in the last decade suggests that the trend toward modernization and improved performance will continue, but not without some variation in approach and in results. Implicit in this scenario are a series of assumptions that would affect overall performance; each of the assumptions below suggests issues that China's leaders will need to address and which, while not reversing the positive direction of improving economic performance, may require some diversion from the planned straight line of growth. Should these assumptions not be borne out over the course of the next decade, China's modernization may fail, leading to slowed growth and the retardation of development; or, one of the other two scenarios described above--Maoist political cycles or steady advancement along a trend--may become more probable. For the present, however, a continued variable pattern of growth would appear the more likely expectation, given these assumptions:

(1) Political support of the principles of modernization, reform, and openness, required for Deng's economic policy, is likely to continue, even after Deng's passing. 17/

- The framework of modernization, openness and reform has been broadly accepted, but the specific policies for proceeding through the various stages of change are still being worked out. To assure continuity of reform, political steps have been taken which are intended to stabilize the leadership and provide for smooth succession. Change after Deng seems likely to move toward a more orthodox Leninist political and economic system rather than a revival of radical Maoism.

- While the system will not move toward pluralistic democracy, the Party and State may be progressively less obtrusive, and may intervene less in the professional processes of the economic system and its responsiveness to market stimulating forces.

- Deng has been successful in eliminating the most obvious and vocal opponents and obtaining a strong consensus for the general framework of economic policies currently pursued. Surface consensus may mask a lack of resolution of fundamental differences in view. Future reform policies represent wide options consistent with the framework of reforms advocated and implemented by current Chinese leaders led by Deng. However, the consensus may break down as the leadership moves from general to specific policies in the post-Deng period.

17/ See articles by Harding, Harry. Political Stability and Succession; Hamrin, Carol Lee. Competing Political-Economic Strategies; and Clarke, Christopher M. Reorganization and Modernization in Post-Mao China. In China's Economy, I.

- The political succession strategy followed to date appears to be successful. That strategy has consisted of placing potential successors in key posts; reorganizing the Party and State institutions (including military) to provide solid bases of political support; convincing the Party of the need for reform; and reinstituting the Chinese political process to protect leadership from serious challenge and charges that reforms threaten economic stability, cultural integrity, and social equality. However, continuation of political support over the long run may fracture, particularly as the impact of specific reforms becomes evident.

- The changes resulting from accelerated economic growth and reform under Deng Xiaoping such as destabilization of the established Communist political economic system, diversification of culture and opening of the society, are less radical than the political-ideological changes instituted under Mao. The full cost of attaining economic goals by the year 2000 is substantial, though perhaps sustainable.

(2) Rural reform will not be overtaken by population pressure that may threaten to swamp production gains; or be offset by social pressures generated by income inequities.

- China hopes to stabilize its population at 1.2 billion, but it is more likely to grow to 1.4 billion before leveling off in the 21st century. The 200 million difference is critical to China.

- Draconian measures to control births through the demographically hazardous period of high fertility may come into conflict with the natural desire for more children.

- The cultural and social impact of increasing inequities and changing social status, resulting from progressively differential incentive systems, may be substantial. The economic restructuring or reform process may create an upper and an under class in rural and urban settings that could generate social and ideological backlash.

(3) Urban Reform will not be frustrated by an inability to choose between the short term political opportunities to move ahead directly toward guidance planning or the more cautious approach of developing a system of monetary and financial measures key to indirect control of management.

(4) Science and technology reform will not be neutralized by conflicts between central and decentralized models, lack of adequate cadres and slow absorption of foreign technology.

- The creation of a new managerial, scientific and intellectual elite may not be deemed sufficiently beneficial to justify its full social, cultural and political costs.

(5) External threats or opportunities will not reverse the modest priority for military modernization.

- Soviet developments in Asia, especially in connection with Vietnam and North Korea, could destabilize the military balance and lead to changes in military postures.
- Opportunities created in Taiwan by succession or other developments may lead to upgrading military preparation if intervention is adopted as a policy.

(6) Opening of the economy may proceed as long as the adverse effects of foreign influences are not more than offset by the developmental benefits.

IV. IMPLICATIONS OF PRC MODERNIZATION FOR THE UNITED STATES, PACIFIC RIM, SOCIALIST COUNTRIES, AND LDCs THROUGHOUT THE WORLD

A. As a Nascent Asian Economic Power

In accomplishing its general goal of growth and modernization by the year 2000, the People's Republic of China will obtain the economic base in rural and urban output necessary to sustain its role as a rising power:

- Per capita income increases will make it possible to provide an increasing share of the populace with an average diet assuring subsistence grains and quality foods, including meat and fish; consumer durables, such as washing machines, television sets, and motorcycles, will become commonly available for those peasants and workers with rising incomes.
- The economic infrastructure--transport and energy networks, housing and commercial services--may be substantially improved, albeit from a very low base.
- The PRC's resource base will be enhanced so that it may project its role as a regional power by supporting regional programs of economic assistance, military affairs, and foreign representation.

B. As A Participant in the Pacific Market

The PRC, with abundant and relatively cheap labor, energy and material resources, and with selective skills in many areas of competitive advantage possesses a potential for expanding exports. The country's ability to import -- a virtually insatiable appetite for products, consumer durables and technology -- will be constrained by its ability to expand exports. Moreover, the development of other means of expanding its foreign economic activities, through the use of credit and joint ventures, for example, will turn on the promise of future exports. Key areas of export development are led by energy--offshore and onshore oil, coal and possibly natural gas. Import requirements will be dependent upon the priorities of the four modernizations.

For advanced technology products, the PRC looks to the OECD countries. Japan's natural advantage in competitive high-technology products and its ability to effectively transfer technology may be tempered by a Chinese desire to diversify its import dependence. Some of the Newly Industrializing Countries, Taiwan and South Korea, are limited trading partners for political reasons, while the Asian-Pacific entrepreneurs--Hong Kong and Singapore--have a central role as direct and intermediary channels.

Participation in the foundation organizations of the world economic community--the International Monetary Fund and World Bank--provides stimulation to growth and adherence to norms of the free-world trading system. If China were to rejoin the GATT, these benefits would be further extended.

C. As a Model for Developing Countries

The size and growth of China may alone enhance China's attractiveness as a model for developing countries, but a number of particular features of China's development may also be of interest to the world's struggling LDCs:

- o Gains in industrial and agricultural growth that are not swamped by population explosions (Egypt, Bangladesh come to mind).
- o Growth without urbanization and its accompanying unemployment, overcrowding and unplanned urban explosions. [Latin American countries, such as Brazil and Mexico, as well as India come to mind.].
- o Manageable environmental pollution. [All developing countries seem to say growth now, quality of life later.]
- o Manageable employment, i.e. minimizing unemployment which can cause the dislocation of growth and the release of labor through technological change.

D. As a Model for Socialist Economic Development

Is it possible for a centrally-controlled society and economy to grow in quantitative and qualitative terms? Is simulation of market efficiency through selective decentralization and devolution of economic power to the enterprises and family plots possible? The tentative answer from the PRC, based especially on rural reform, is -- perhaps. The Soviet Union, East Europe and many other countries with centrally controlled economies watch Chinese developments with interest.

The Chinese experiment raises other questions as well. Can measures of economic efficiency be attained in a flexible Marxist-Leninist framework? The key to adherence to Marxist dictates is ownership. Are private and socialist ownership antithetical? Can socialist ownership, such as in the family responsibility system in Chinese agriculture, attain the advantages in efficiency of private ownership, while staying faithful to Marxist injunctions against the exploitative evils of private property? Some Chinese say yes, as do some East European ideologists.

Is a Leninist system--a flexible view of Lenin's commanding heights--a viable ideological construct for retaining both ideological and political purity and market simulating efficiency? Some would see these ideological discussions as just providing "fig leaves" for renunciation of Marxist-Leninism. Others would argue that these critics are too mechanical in their interpretation of the ideology.

However the flexibility of ideology is worked out, the political imperative, for China as well as the other socialist nations, is to retain the central role of the Party and the centralization of key political powers. The Party may nonetheless withdraw from its direct role as economic interventionist. This selective withdrawal of the Party would raise the question, however, of whether the role of the Party can be maintained if its tool for controlling appointments and personnel--the nomenklatura system--is eliminated or revised.

Political and ideological comity between China, East Europe and the Soviet Union may lead to substantial expanded trade. There is a natural fit between the economies of the PRC and the Soviet Union:

- o Chinese exports of food, textiles and other materials to the U.S.S.R., especially to deficient areas of Siberia.

- o Soviet exports of industrial equipment to the PRC to upgrade Soviet projects of the 1950s, assist in electrification, construction of railroads, as well as to provide key materials, such as timber products.

E. As a Pacific Regional Partisan with the United States

What would the United States prefer in Chinese development? An economically healthy, peaceful state that does not threaten the sovereignty of its neighbors or ally itself with the aggressive plans of the Communist countries of Asia (the Soviet Union, North Korea, Vietnam). Moreover, the development of expanding and mutually beneficial trade would add to the community of bilateral interests.

Chinese leaders include a doubling of bilateral trade in their objectives for the year 2000. Trade turnover has been reportedly expanding in recent years from $4.8 in 1980 to $7.7 billion in 1985.

Future economic development may turn on the development of large-scale joint ventures:

- Oil complexes--offshore and onshore.
- Coal mining and distributive complexes.
- A comprehensive energy program, including hydro, nuclear, and electric power transmission.
- A comprehensive transport system.

The Report of
The Advisory Group on Economic Structural Adjustment for International Harmony

THE MAEKAWA REPORT

The Report of the Advisory Group on Economic Structural Adjustment for International Harmony submitted to the Prime Minister, Mr. Yasuhiro Nakasone on April 7, 1986

This Advisory Group was requested by the Prime Minister on October 31, 1985, to conduct a study on policy measures, from medium and long term perspectives, concerning Japan's economic and social structure and management in response to the recent environmental changes surrounding Japan in the international economic situation.

Accordingly, the Group has met 19 times during the last five months to hold free discussions among its members. Following is the report on the result of those discussions.

The Group consists of following members:

Haruo Maekawa
Shoichi Akazawa
Takashi Ishihara
Ichiro Isoda
Tadanobu Usami
Yoshio Okawara
Saburo Okita
Hiroto Oyama
Hiroshi Kato
Yutaka Kosai
Goro Koyama
Mamoru Sawabe
Setsuya Tabuchi
Minoru Nagaoka
Takashi Hosomi
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Takashi Mukaibo

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I. Background

1. The Japanese Economy Today

Having achieved very rapid economic growth in the forty years since the end of the war, Japan today occupies an important position within the international community.

Japan's international balance of payments has tended to show increasing current account surpluses in the 1980s. In 1985, in particular, this surplus was unprecedentedly large, i.e. 3.6% of GNP.

It is imperative that we recognize that continued large current account imbalances create a critical situation not only for the management of the Japanese economy but also for the harmonious development of the world economy.

The time has thus come for Japan to make a historical transformation in its traditional policies on economic management and the nation's life-style. There can be no further development for Japan without this transformation.

2. A National Goal for Japan

Setting as a medium-term national policy goal, the Government should announce its determination, both domestically and internationally, to attain the goal of steadily reducing the nation's current account imbalance to one consistent with international harmony.

The large current account surplus is basically linked with Japan's economic structure such as being export-oriented, and there is an urgent need for Japan to implement drastic policies for structural adjustment and to seek to transform the Japanese economic structure into one oriented toward international coordination.

The process of achieving this goal should also entail efforts to enhance the quality of the nation's living standard, and it is imperative for us to realize that our success in achieving this goal will be essential in determining Japan's future in the international community.

In all of this, Japan should undertake responsibilities commensurate with its economic position and strive for harmonious co-existence within the world economy, as well as working to contribute to the world community not only economically but also in the scientific and technological, cultural, and academic fields.

This Group therefore recommends a number of specific steps that the Government should take in keeping with the following principles for the attainment of this goal.

3. Principles

In making these recommendations, we have kept in mind the need to achieve these policy goals through balanced economic growth and the resultant import expansion to maintain and strengthen the free trade system and to work for sustained and stable world economic growth.

(1) Policies based upon Market Principles

In order to make Japan more internationally open, policies based upon market mechanisms should be implemented from the viewpoint of "freedom in principle, restrictions only as exceptions." Accordingly, further improvement in market access and thorough promotion of deregulation should be carried out.

(2) Policies from a Global Perspective

Believing that the Japanese economy can only develop within a context of sustained and stable growth of the world economy, we find it imperative that Japan rectify its economic structure on its own initiative. At the same time, we believe that world economic growth requires efforts and cooperation of all countries, and policy coordination must be achieved in structural adjustment and other fields.

(3) Continued Long-term Efforts

Since the process of reforming the economic structure and improving the basic character of our economy is a long-term one, efforts to this end should be made continuously and from a long-term perspective.

However, relevant policy must be initiated as soon as possible.

II. Recommendations

In seeking to orient the economy toward internationl harmony and make Japan an international state, it is imperative that, along with striving for economic growth led by domestic demand, the Government promote basic transformations in the nation's trade and industrial structure. At the same time, the Government must work for the realization and stabilization of the exchange rate at an appropriate level and must further promote the liberalization and internationalization of the nation's financial and capital markets. Furthermore, it is important for Japan to contribute actively to the well-being of the world community through international cooperation. In the implementation of these recommendations, fiscal and montary policy, including taxtation, also has a significant part to play. Especially, the preferential tax treatments for savings should be fundamentally reviewed.

1. Expanding Domestic Demand

Promoting the transformation from export-led economic growth to that driven by domestic demand requires that the Government put firmly into place domestic demand expansion policies that have large multiplier effects and will lead to increased private consumption.

(1) Promoting Housing Policies and Urban Redevelopment

Efforts should be made toward a fundamental reform in Japanese housing policy and strengthening and broadening of measures to promote housing is required. In large urban centers, in particular, creation of new residential areas closer to offices by redeveloping existing areas and construction of new residential neighborhoods are to be promoted. Also, urban facilities are to be expanded and improved.

There are a number of points which should be kept in mind in carrying out these efforts.

a. The scale of such projects is to be expanded centering on the mobilization of private-sector vitality. Steps must therefore be taken to ease regulations and to provide pump-priming financial incentives.

b. Tax deductions should be expanded for acquisition of houses.

c. Measures should be taken to keep land prices stabilized, e.g., re-zoning of urban areas, relaxing local government residential development guidelines, and easing the restrictions on building size and land use.

d. Efforts should be made to accelerate the settlement of problems arising from land use among those concerned.

(2) Stimulating Private Consumption

Along with the appropriate distribution of economic growth in wages, tax cuts increasing disposable income are effective in expanding private consumptions. People should have more free time through reduced working hours, and the active use of paid leaves for longer periods should be encouraged. The total working hours per year in line with the industrialized countries of Europe and North America and early realization of complete five-day work weeks should be pursued in the private sector, while the efforts should be made for speedy implementation of these policies in the public and financial sectors.

(3) Promoting Social Infrastructure Investment by Local Government

A radical increase in the capital formation by local governments is essential to spreading nationwide the impact of stronger domestic demand. Accordingly, in order to promote infrastructure developments, local independent works should be enlarged by making use of local government loans.

2. Transformation to an Internationally Harmonious Industrial Structure

The shift to internationally harmonious trade and industrial structure should basically be pursued through market mechanisms, but additional efforts should also be made through the following measures.

(1) Promoting Transformation of Industrial Structure and Positive Industrial Adjustment

Positive industrial adjustment must be promoted to encourage the international division of labor.

To this end, it is necessary, while paying due consideration to the impact on small and medium size businesses, to promote actively the transformation of the nation's industrial structure. In this connection, the structural reforms now being promoted under current laws should be accelerated. Taking account of the serious impact on local economies; coal mining policy should be reviewed with a view to lowering the level of domestic output drastically and increasing imports.

Also, in promoting industrial restructuring, it is important to encourage technological research and development, the growing diffusion and application of information technology in the economy and society, and the development of the service sector accelerated by the greater availablity of free time and diversification of consumption patterns.

(2) Promoting Direct Investment

Direct overseas investment plays an important role in rectifying Japan's external economic imbalances and in promoting the host country's economic development. Overseas investment has been expanding rapidly in recent years, and, with due consideration to the impact on domestic employment and the economy, this should be further encouraged. Accordingly, conclusion of bilateral agreements concerning protection of investment should be encouraged, overseas investment insurance schemes should be improved, and participation in Multilateral Investment Guarantee Agency (MIGA) should be undertaken and other governmental measures to support overseas investment should be reinforced. It is also necessary to expand economic cooperation to improve the environment for investment in the developing countries.

Foreign investment in Japan should also be encouraged with improved conditions for financial assistance, increased supply of information, and other measures. Furthermore, industrial cooperation should be actively promoted including technology exchanges and cooperation in third-country markets. Especially, setting up of a private-sector-led institution for industrial cooperation for the purpose of enhancing personnel exchanges should be encouraged.

(3) Promoting Agricultural Policies befitting to an Age of Internationalization

In order to achieve maximum productivity with land conditions and other constraints, the Government should have a clear perspective for Japan's agriculture in the future. To this end, the Government should work to achieve a thorough structural improvement, thereby promoting agricultural policies befitting an "Age of Internationalization". In so doing, priorities should be given to the policies focused on fostering core farmers for the future, and price policies should be reviewed and rationalized toward greater use of market mechanisms and active promotion of structual policies.

With the exception of basic farm products, efforts should be made toward a steady increase in imports of products (including agricultural processed products) whose domestic prices and the international market prices differ markedly. These price disparities should be reduced, while agriculture should be rationalized and made more efficient.

With regard to products subject to quantitative import restrictions, efforts should be made to improve market access under the future perspective for making the Japanese market more open, while taking account of developments in the relevant consultations and negotiations including the GATT new round.

3. Further Improving Market Access and Encouraging Import of Manufactured Goods

(1) Further Improving Market Access

Full implementation of the Action Program for Improved Market Access should be promoted in the areas of tariffs, import restrictions, standards and certification, and government procurement and so on. Also the Office of Trade and Investment Ombudsman (O.T.O) should be reinforced including the study of the possibility of giving a legal basis to it, in order to further improve market access.

(2) Encouraging Imports of Manufactured Goods

Further active efforts should be made to encourage imports of manufactured goods, together with steady implementation of various structural measures, including overseas investment which will contribute to the international division of labor such as local production and expanded imports of semi-finished and finished products. Together with promoting the streamlining of distribution mechanisms and conducting review of the various restrictions pertaining to distribution and sales, efforts should also be made to ensure the strict enforcement of the Antimonopoly Law for the prevention of unfair business transactions (1) and to strengthen domestic arrangements to eliminate illegal acts with regard to foreign trade marks and counterfeit products.

(1) This should be done with special attention to monitoring the registration of international contracts, dealing harshly with unfair or exclusive trading practices, and checking that nothing is done to unfairly prevent parallel imports.

Along with seeking to expand import promotion policies through intensifying consumer-directed import promotion campaigns and ensuring the complete availability abroad of information on the Japanese market and distribution systems, efforts should be made to promote expanded economic cooperation and private-sector technology transfers to contribute to expanded imports of manufactured goods from developing countries.

(3) Prudent Behavior of Private Companies

Considering the strong possibility of frictions caused by the behavior of private companies which tend to pursue expanded market share at all costs, it is hoped that Japanese companies will behave in awareness of their international responsibilities.

4. Stabilization of Exchange Rates and Liberalization and Internationalization of Financial and Capital Markets

(1) Stabilizing and Sustaining Appropriate Exchange Rates

In achieving a proper balance between domestic and external demands, it is essential that exchange rates be stable and in line with economic fundamentals. While the government needs to place emphasis on exchange rate stability in its policy management, this goal cannot be achieved by Japanese policy efforts alone, and international efforts are needed.

Under the present circumstances, arrangements for stability must be considered within the framework of floating exchange rates, and elimination of major disparities in the economic performance of the leading industrialized countries is the underlying basis of exchange rate stability. There is, therefore, a clear need for a high level of policy coordination among these countries. However, since there is no guarantee that exchange rates will always reflect the fundamentals, cooperation and intervention by the countries concerned can be effective tools for correction.

While ensuring international compatibility of basic economic policy, it is important that efforts be made to build upon the accumulated experiences of international cooperation in developing a framework for future stability.

(2) Liberalization of Financial and Capital Markets and Internationalization of the Yen

With the liberalization of financial and capital transactions, transactions now take place on a global scale, and Japan should ensure that its financial and capital markets are commensurate with its economic importance. This will also facilitate the internationalization of the yen.

Thus efforts should be made to further liberalize financial and capital transactions and to expand transactions by non-residents both for financing and for investment.

Internationalization in the latter respect has been relatively slow in Japan. It is now essential to develop market facilities for funds from abroad so as to achieve better balance between financing and investment.

In strengthening investment markets,

a. There is a need to diversify investment instruments, and particularly the development of short-term financial markets is an urgent task.

b. The expansion and strengthening of secondary markets and the internationalization of trading requires international compatibility of market arrangements and trading practices, in particular, with respect to taxation with due attention to the international point of view.

5. Promotion of International Cooperation and Japan's Contribution to the World Economy Commensurate with its International Status

The following policies should be implemented to promote international cooperation and to contribute to the world economy, while appropriate measures on necessary financial resources should be taken.

(1) Promotion of International Cooperation

a. Expanding Imports from Developing Countries

Efforts should be made to encourage imports of manufactured goods from developing countries through such means as technology transfer and expanded investment from Japan which will contribute to promoting improvements in the export industries of developing countries and further cooperation with their market penetration efforts.

b. Alleviation of the Debt Problem

Japan should work in cooperation with other leading industrialized countries to promote efforts for lower interet rates, to increase the official financial flow to developing countries, to strengthen the financial basis of multilateral development banks as well as to further improve their efficiency, and to give consideration to the impact of the debt problem of developing countries on private financial institutions.

c. Promoting Economic and Technical Cooperation

Every effort should be made to achieve as early as possible the current Medium-Term Target to expand Japan's official development assistance (ODA). It is also important that the non-government organizations (NGO) be mobilized in this effort. As for the contents of economic and technical cooperation, it is necessary to expand technical assistance, place emphasis on training of assistance personnel, improve the grant element, restrain mixed credits, and promote untied aid.

d. Promoting International Exchanges in the Fields of Science and Technology and Culture

Japan should actively contribute to the creation of new science and technology for the twenty-first century. As well as promoting research and development in basic science and technology, Japan should promote international research cooperation in these fields.

Efforts should be made to promote Japanese language education and Japanese studies overseas, to support personnel exchanges, and to strengthen international broadcasting.

Efforts must also be made to adapt to the age of internationalization such as by opening doors of academic and research institutions to foreigners, arranging to accept more foreign teachers and students, and to accommodate Japanese students, returning from overseas.

(2) Active Promotion of the GATT New Round

While responding positively to the matters of interest to developing countries, the Government should actively participate in the establishment of international rules in such new fields as trade in services and intellectual property rights. The Government should also seek to improve the GATT rules and strengthen the GATT system in order to restore the credibility of the GATT.

It is hoped that the Government will actively conduct negotiations on tariffs in accordance with the decision in the Action Program with regard to tariffs of industrial products.

6. On Fiscal and Monetary Policy Management

In the implementation of these recommendations, fiscal and monetary policy has a significant part to play.

In implementing fiscal policy, it is necessary to maintain the basic policy stance of fiscal reform to end its dependency on deficit-financing bonds, and also to respond flexibly in an effort to achieve economic and social balance, on a medium- and long-term basis, with creative efforts for the appropriation of fiscal resources with effectiveness and priority, for the mobilization of private-sector vitality, and for deregulation.

The tax system should be reviewed from the perspectives of equity, fairness, simplicity, economic vitality, and choice, as well as from an international point of view. The preferential tax treatment for savings, in particular, should be fundamentally reviewed in light of these principles, including abolition of the tax exemption of interest on small-amount savings.

While ensuring currency stability, flexible management of monetary policy is necessary to realize an economy led by domestic demand.

7. Follow up

The Group strongly hopes that the Government will make necessary examinations on these recommendations as soon as possible and take necessary measures for their implementation. The Group further hopes that necessary arrangements will be made so that appropriate follow-ups will be made for the implementation of those measures.

III. Conclusion

The Government obviously has a very important role to play in transforming Japan's social and economic structure for greater harmony with the international community, but each and every Japanese should also be fully aware that Japan cannot develop unless it also contributes actively to the international community. It is imperative that every effort be made for attainment of this national goal, and the Group thus very much hopes that the Government will make every effort to implement these recommendations with the full understanding and support of the entire nation.

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